DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

NICARAGUA

GLOBAL MULTISECTOR CREDIT PROGRAM

(NI-0167)

LOAN PROPOSAL

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BASIC SOCIOECONOMIC DATA

For basic socioeconomic data, including public debt information, please refer to the following address:

English:
http://www.iadb.org/RES/index.cfm?fuseaction=externallinks.countrydata

Spanish:
http://www.iadb.org/RES/index.cfm?fuseaction=externallinks.countrydata

ABBREVIATIONS

ASOMIF	Asociación Nicaragüense de Instituciones de Microfinanzas [Nicaraguan Association of Microfinance Institutions]
BCN	Banco Central de Nicaragua [Central Bank of Nicaragua]
BLADEX	Banco Latinoamericano de Exportaciones [Latin America Export Bank]
BPI	Bonos de Pago por Indemnización
CABEI	Central American Bank for Economic Integration
CAR	Capital adequacy ratio
CENIS	Certificado de Inversiones Nicaragüense [Nicaraguan investment certificate]
FAO	United Nations Food and Agriculture Organization
FNI	Financiera Nicaragüense de Inversiones, S.A.
FOGADE	Fondo de Garantía de Depósitos [Deposit Guarantee Fund]
GDP	Gross domestic product
IFI	Intermediary financial institution
IIC	Inter-American Investment Corporation
IMF	International Monetary Fund
MARENA	Ministerio del Ambiente y los Recursos Naturales [Ministry of the Environment and Natural Resources]
MHCP	Ministerio de Hacienda y Crédito Público [Ministry of Finance]
MIFIC	Ministerio de Fomento, Industria y Comercio [Ministry of Development, Industry, and Commerce]
NGO	Nongovernmental organization
PCR	Project Completion Report
ROA	Return on assets
ROE	Return on equity
SBIF	Superintendencia de Bancos y Otras Instituciones Financieras [Office of the Bank Examiner]
UNDP	United Nations Development Programme
ERCERP	Enhanced Strategy for Economic Growth and Poverty Reduction
HIPC	Highly indebted poor countries (initiative)

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NICARAGUA

IDB LOANS

APPROVED AS OF DECEMBER 31, 2003

	US$Thousand	Percent
TOTAL APPROVED	***2,009,521***	
DISBURSED	*1,489,921*	*74.1%*
UNDISBURSED BALANCE	*519,600*	*25.9%*
CANCELLATIONS	*41,603*	*2.1%*
PRINCIPAL COLLECTED	*332,804*	*16.6%*
APPROVED BY FUND		
ORDINARY CAPITAL	*259,279*	*12.9%*
FUND FOR SPECIAL OPERATIONS	*1,682,102*	*83.7%*
OTHER FUNDS	*68,139*	*3.4%*
OUSTANDING DEBT BALANCE	***1,157,117***	
ORDINARY CAPITAL	*139,748*	*12.1%*
FUND FOR SPECIAL OPERATIONS	*1,011,664*	*87.4%*
OTHER FUNDS	*5,705*	*0.5%*
APPROVED BY SECTOR		
AGRICULTURE AND FISHERY	*364,055*	*18.1%*
INDUSTRY, TOURISM, SCIENCE TECHNOLOGY	*78,182*	*3.9%*
ENERGY	*204,359*	*10.2%*
TRANSPORTATION AND COMMUNICATIONS	*266,865*	*13.3%*
EDUCATION	*22,240*	*1.1%*
HEALTH AND SANITATION	*175,777*	*8.7%*
ENVIRONMENT	*64,359*	*3.2%*
URBAN DEVELOPMENT	*57,014*	*2.8%*
SOCIAL INVESTMENT AND MICROENTERPRISE	*284,113*	*14.1%*
REFORM _PUBLIC SECTOR MODERNIZATION	*461,966*	*23.0%*
EXPORT FINANCING	*1,826*	*0.1%*
PREINVESTMENT AND OTHER	*28,765*	*1.4%*

***** Net of cancellations with monetary adjustments and export financing loan collections***

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NICARAGUA

STATUS OF LOANS IN EXECUTION AS OF DECEMBER 31, 2003

(Amounts in US$ thousands)

APPROVAL PERIOD	NUMBER OF PROJECTS	AMOUNT APPROVED *	AMOUNT DISBURSED	% DISBURSED
REGULAR PROGRAM				
1996 - 1997	4	119,990	108,090	90.08%
1998 - 1999	9	253,175	137,465	54.30%
2000 - 2001	18	313,203	48,198	15.39%
2002	6	142,900	14,880	10.41%
TOTAL	37	$829,268	$308,633	37.22%

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Nicaragua

Tentative Lending Program

2003

Project Number	Project Name	IDB US$ Millions	Status
NI0167	Multisectoral Global Program	30.0	
NI0172	Modernization of the State and Fiscal Reform	25.0	
NI0174	National Program for Competitiveness	7.5	
NI0152	Masaya Basin and Municipality Env Prog	10.0	
	Total - A : 4 Projects	**72.5**	
NI0171	Basic Education for the Young and the Adults	30.0	
NI0170	Road Integration Program PPP	30.0	
NI0168	Citizenship Security Prog.	25.0	
	Total - B : 3 Projects	**85.0**	
	TOTAL 2003 : 7 Projects	**157.5**	

2004

Project Number	Project Name	IDB US$ Millions	Status
NI0155	Integral Attention to poor neighborhoods	20.0	
NI0176	Handicap Prevention and Recuperation	15.0	
NI0113	Multiphase Secondaryr Road Program	30.0	
NI0162	Technical Education System Modernization	20.0	
NI0177	Probidad Administrativa	10.0	
NI0178	Anti-Corruption National Plan	10.0	
NI0179	Technical Cooperation Loan E-Government	3.0	
NI0180	VIII population and IV housing census	13.0	
	Total - A : 8 Projects	**121.0**	
	TOTAL - 2004 : 8 Projects	**121.0**	

Total Private Sector 2003 - 2004	**0.0**
Total Regular Program 2003 - 2004	**278.5**

*** Private Sector Project**

GLOBAL MULTISECTOR CREDIT PROGRAM

(NI-0167)

EXECUTIVE SUMMARY

Borrower:	Financiera Nicaragüense de Inversiones, S.A. (FNI)	
Guarantor:	Republic of Nicaragua	
Executing agency:	Financiera Nicaragüense de Inversiones, S.A. (FNI)	
Amount and source:	IDB (FSO): Local counterpart: Total:	US$30.0 million US$ 7.2 million US$37.2 million
Financial terms and conditions:	Amortization period: Grace period: Disbursement period: Commitment period: Interest rate: Inspection and supervision: Credit fee:	40 years 10 years Minimum: 36 months Maximum: 48 months 30 months 1% during the first 10 years 2% thereafter 1% 0.50%

Objectives: The objective of the proposed operation is to support the development of private business, especially small and medium-sized enterprises, by expanding the supply of medium- and long-term financing.

Description: The program will provide resources to Financiera Nicaragüense de Inversiones (FNI) to finance credit for private enterprises to be granted through eligible financial intermediary institutions (IFIs) (credit component), as well as technical assistance resources (technical assistance component).

The resources for the credit component will be used exclusively for FNI operations with supervised formal financial intermediaries that meet the program eligibility criteria and comply with the Credit Regulations. The subloans will be granted to startup and existing private enterprises in all sectors of the economy, whether they be in manufacturing, trade, or services, in both urban and rural areas. The subloans will be used to meet the need for credit in: (i) the procurement of fixed assets; (ii) working capital base for expansion, conversion, or modernization of production; or (iii) the hiring of technical and management services to support investments in fixed assets.

The program will also provide technical assistance resources for the technical and institutional strengthening of the FNI to help it access the domestic and international capital markets in the medium term. Under the technical assistance component, the following six subcomponents will be financed: (i) review and adjustment of the pricing system for IFIs to make it more consistent with the market, including an analysis of distortions due to the competitive supply of resources and the viability of auctioning, which would be used as a competitive instrument for resource allocation; (ii) development and implementation of a strategic plan for the FNI; (iii) improvement of the credit risk management system to include more projections and preventive factors to help foresee potential market risks; (iv) development of alternative sources of funding that include capital market activities; (v) design of new products; and (vi) improved environmental management by developing a system to identify and monitor enterprises and projects that need measures to mitigate their environmental impact, training on environmental risks for FNI and IFI staff, and promotion and dissemination.

The resources will be loaned to the IFIs in United States dollars, and the IFIs will grant financing to the subborrowers on competitive free-market terms and conditions, both in the selection of subborrowers and the establishment of interest rates on the subloans. The IFIs will fully assume the credit and exchange risk of the subloans.

The Bank's country and sector strategy: The proposed program is fully consistent with the Bank's strategy for cooperation with Nicaragua, as set forth in the country strategy paper, with regard to the objective of reactivating economic growth and improving competitiveness by supporting the private sector with the execution of projects to expand productive capacity. The operation will also help the FNI and the financial sector during a transition stage to greater involvement in the international financial markets.

Coordination with other donors: The Bank coordinates its efforts closely with other multilateral and bilateral institutions to assist the FNI. Specifically, the Bank has established mechanisms for cooperation and exchanges with the World Bank, which is preparing a technical assistance operation in support of financing for microenterprise and rural areas. Some components of this operation will be carried out through the FNI. The program which does not envisage loan financing, will be supplemented with the activities planned under the present operation, boosting FNI capacity to address the needs of different market sectors. Moreover, the Bank is working closely with agencies involved in the financing sector, particularly the World Bank and the International Monetary Fund, by participating in joint review and analysis missions (paragraph 1.52).

Environmental and social feasibility: The direct environmental impact of the program will be neutral insofar as it will finance second-tier banking operations. However, the individual investments financed may have an adverse environmental impact. In order to mitigate such impact, all financing with program resources must have the necessary environmental permits issued according to Nicaraguan legislation by the competent authorities in the Ministry of the Environment and Natural Resources (MARENA), with monitoring according to the Credit Regulations. Moreover, the Credit Regulations stipulate that the end-borrowers must comply with the applicable labor law and social legislation.

Benefits: The proposed program is part of the Bank's efforts to support the Nicaraguan authorities in promoting sustainable economic growth through increased private-sector productivity and competitiveness. This requires an ongoing process of modernization, industrial conversion, and expansion of productive assets, which requires access to medium- and long-term financing. Given the incipient development of the capital markets and the obstacles barring access to such markets, especially for small and medium-sized enterprises, the banking sector continues to be the main source to meet financing needs despite the constraints it faces in terms of long-term funding. The proposed program will help meet the need for private investment, making up for the shortcomings of the domestic financial market with regard to savings.

Risks: The success of the program will depend to a great extent on maintaining a stable macroeconomic policy conducive to expansion of economic activity in the country and increased demand for credit on the part of the private sector. However, the program runs the risk of the country's economy contracting beyond the current revised projections, due to a slowdown in economic activity, particularly in international trade and a deterioration in the terms of trade. This risk will be mitigated under the program, mainly by means of the conservative sizing of the credit component and its execution period, while still reflecting an analysis of the potential demand for credit in the real sector and the absorption capacity of the IFIs, as well as development of the FNI's flow of funding.

The vulnerability of the country's financial system could pose potential risks for the operation. It will be substantially mitigated by the progress made in recent years to establish prudential standards and strengthen financial regulation, as well as to improve the capacity of the oversight authorities to enforce standards and oversee the system.

With regard to operational risk, the FNI has made significant progress in its institutional consolidation. Maintaining this capacity at high levels will be a requirement for it to successfully expand placements without jeopardizing the financial position of the institution. This risk will be mitigated by the continued institutional strengthening of FNI's risk analysis capacity, as well as by the strict eligibility criteria for the financial intermediaries.

Special contractual clauses:

Prior to the first disbursement of the resources for the technical assistance component, the FNI must submit:

(i) a plan of operations for technical assistance with a schedule of execution approved by the FNI board of directors, in terms acceptable to the Bank (paragraph 3.7); and

(ii) the name of the FNI manager appointed as permanent liaison with the MARENA, who will periodically evaluate enforcement and efficiency of regulations on environmental protection under the program (paragraph 3.9).

Prior to the first disbursement of the resources for the credit component, the FNI must submit:

(i) evidence that the Credit Regulations have been approved by the FNI board of directors, on the terms previously agreed upon by the Bank (paragraph 3.6); and

(ii) the findings of the study and review of FNI rate-setting policy and system for IFIs. The cost of the consultants hired for this purpose will be financed retroactively, provided that the hiring procedures followed are consistent with the Bank's procurement rules (paragraph 3.5).

Prior to the last disbursement of the resources for the credit component, the FNI must submit:

(i) the terms of reference agreed upon with the Bank for the ex post evaluation of the program (paragraph 3.19).

Other conditions: During program execution, the FNI shall ensure that: (a) the proportion of its portfolio in arrears does not exceed 1.25% of its total loan portfolio, and (b) its operating expenses for the preceding12 months do not exceed 2% of its average loan portfolio for the same period (paragraph 3.6).

Poverty-targeting and social sector classification: This operation does not qualify as a social equity-enhancing project, as described in the key objectives for Bank activity set forth in the Report on the Eighth General Increase in the Resources of the Bank (document AB-1704). Nor does it qualify as a poverty-targeted investment (PTI).

Exceptions to Bank policy: A revolving fund equivalent to 10% of the loan amount will be established to cover the liquidity requirements of the credit and technical assistance components under the program, taking into account the relatively small size of the program and based on experience in similar operations (policy OA-345).

Retroactive financing: Retroactive financing is requested in an amount of up to US$100,000 to cover the cost of consulting services hired to move forward with the works of subcomponents 1, 2, and 3 of the technical assistance component, as indicated in paragraph 2.24.

Procurement: The procurement of goods and services will be governed in accordance with Bank policies and procedures. International competitive bidding will be required for the hiring of consulting services in amounts equal to, or greater than, US$200,000 equivalent. The program does not envisage construction works or procurement of goods in amounts above US$250,000 equivalent.

I. FRAME OF REFERENCE

A. Introduction

1.1 The objective of the program is to support the development of private means of production in Nicaragua by providing medium- and long-term financing for the startup, expansion, modernization, and diversification of private enterprises. The proceeds of this global multisector loan will be channeled through supervised financial intermediaries that meet the technical and financial eligibility criteria for the program. The program will emphasize channeling resources to small and medium-sized enterprises involved in production, which tend to have greater difficulty accessing long-term financing. It was developed in response to a request by the Government of Nicaragua dated 10 July 2002 for continued Bank support for modernization and deepening of the financial sector and enhanced economic competitiveness. The program will also help strengthen Financiera Nicaragüense de Inversiones, S.A. (FNI) and expand its technical and financial capacity, in its role as a second-tier finance company, with a view to enhancing its access to resources on the capital markets.

B. Macroeconomic environment

1.2 In the 1990s, Nicaragua's economic and social development was typical of an economy in transition, moving from a State-dominated economic model to a market model focusing on the private sector as the provider of goods and services and the State as regulator. During that time, the country made progress in the process of reorganization and establishment of an appropriate institutional framework for private initiative to operate as the axis of development. In addition, it implemented a number of measures for macroeconomic stabilization and adjustment, which helped reduce the average inflation significantly, from hyperinflationary levels to an average of 11% in the second half of the decade and a decrease in the current account deficit from 49.6% of gross domestic product (GDP) to 39.4%.[1] Nicaragua continues to be the country with the lowest per capita income in Central America, with little variation in its social indicators over the past few years.

1.3 In 2001, Nicaragua reported a real growth of 3% and an annual inflation rate of 4.7%, while its currency experienced a 6% devaluation. In 2002, modest growth of approximately 1% is expected, with inflation at 6%. This growth rate reflects the slowdown that had been observed in previous years.[2] The low activity level was influenced by slower growth in the agricultural sector and the economic slowdown

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[1] This document includes references to GDP and GDP coefficients for purposes of comparison, even though it is recognized that the data imply a statistical distortion due to the assumed substantial underassessment of GDP. For conversions from local currency (Nicaraguan córdobas) to United States dollars, the official exchange rate for the dollar, as of 31 December each year, was: 11.1938 (1998), 12.3183 (1999), 13.0573 (2000), 13.8408 (2001), 14.0411 (3/2002), and 14.2466 (6/2002).

[2] In 1999 and 2000, GDP increased 7.4% and 5.5%, respectively.

in the United States,[3] along with the decrease in public spending due to budgetary constraints in 2002 and the passive approach of private investment in the face of the political uncertainty. The decline in agricultural growth was due to the severe drought and lower world prices for traditional exports.

1.4 Although the balance of payments is expected to improve in 2002, the external sector continues to be vulnerable due to the magnitude of the trade deficit and the inadequate level of international reserves.[4] In 2001, exports of goods dropped by 6%, down to a level similar to that of the late 1970s, covering barely one third of imports. Export-oriented agricultural production contracted by 10% due to the drop in coffee prices, the main crop (25% of total exportable goods), which have hit historic lows. The current-account deficit increased considerably, reaching 35% of GDP in 2001. It improved slightly in 2002 to 32% of GDP as a result of lower fiscal spending and a slowdown in the growth of credit to the public sector. The imbalance, financed mainly by the Central Bank of Nicaragua (BCN), was reflected in a US$170 million reduction in net international reserves in 2001. This figure is significant, considering that family remittances, which have been on the rise in recent years, helped offset the deficit.

1.5 Implementation of the structural reforms during the administration of President Alemán (1997-2001) could not be completed because of the banking crisis and the presidential elections, thus exacerbating the climate of uncertainty. After intervention in two weak banks in 2000, one of which was the largest in the system, in 2001 the government had to intervene in two more banks, whose assets were auctioned off to other banks (see paragraph 1.12). The 2001 elections caused current expenditures by the central government to increase by 25% and the combined public sector deficit, not including grants,[5] totaled 16.1% of GDP. As a result, the goals agreed upon with the International Monetary Fund (IMF) could not be achieved.[6] In 2002, public finances improved, since the deficit declined to 10.2% of GDP as a result of drastic cutbacks in spending and higher tax collections. Half of the fiscal deficit was financed with BCN credit, one third with external funds, and the balance with the proceeds of privatizations.[7]

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[3] The country's main trading partners continue to be the United States and countries of Central America, which together account for 70% of exports and 50% of imports.

[4] The balance of adjusted net international reserves was only US$16 million at year-end 2001 and US$21 million as of July 2002.

[5] Grants have represented on average 8% of GDP over the past five years.

[6] The interim program agreed upon targeted a deficit (exclusive of grants) of 4.8% of GDP.

[7] Through privatization, the government sold 40% of its interest in the telephone company in August 2001, but postponed the sale of its hydroelectric power plant to 2003.

1.6 Government overspending forced the authorities to carry out open market operations to sterilize excess liquidity by issuing government securities such as Nicaraguan Investment Certificates (CENIS) and Special Investment Securities (TEI). In addition, when the bank crisis broke, the government, through the BCN, guaranteed all deposits issuing CENIS for approximately US$350 million in 2000-2001. These obligations had the potential to cause vulnerability because the CENIS were indexed to the United States dollar and did not mature for two or three years. In addition to the debt represented by the CENIS and other BCN instruments, there is the balance of the compensation payment bonds (BPI), which will begin to mature in 2004, by which time outstanding domestic debt may reach close to 60% of GDP.[8]

1.7 The new administration that took office in 2002 faces major challenges to achieve sustained growth. Its most pressing task it to take steps to close the fiscal and external gaps. In March 2002 the government authorities and the IMF negotiated the components of a macroeconomic program, to be supported by a loan under the Poverty Reduction and Growth Facility (PRGF).[9] The negotiations concluded with the signing of a Letter of Intent and submittal of the program for the next three years to the IMF Executive Board in mid-November and early December, respectively. The main features of the program approved are narrowing the fiscal deficit, reducing BCN credit to the government, and increasing international reserves. The plan for substantial fiscal adjustment and reduction in external debt is fully consistent with the medium-term macroeconomic policy set by the government under its poverty reduction program.

C. Financial sector developments

1.8 In the 1990s, the financial system in Nicaragua underwent an in-depth transformation. The system made up entirely of State-owned intermediaries in 1990 and focusing on commercial banks became an almost fully private system a decade later, with a broad array of bank and nonbank services and an emerging capital market. In late 1991, 14 private institutions had joined the banking market, while State banks ceased to operate as first-tier suppliers.[10]

1.9 At the same time, the institutional framework for financial sector regulation and oversight was established, with the creation of the Office of the Bank Examiner

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[8] Domestic debt service totaled US$350 million in 2002 and will be an estimated US$227 million in 2003 and US$283 million in 2004, and average US$90 million for the remainder of the decade.

[9] Nicaragua reached the Decision Point under the HIPC Initiative in December 2000. Accordingly, its debt reduction may total US$3.267 billion in net present value, in addition to the bilateral agreements reached under the initiative.

[10] As of June 2002, there was only one first-tier State-owned bank in operation, Banco de Crédito Popular, although in 2000 it had closed down its operations and was being liquidated.

(SBIF) in 1991, reform of the BCN, banking legislation reform, and the establishment of prudential standards. The latter were adjusted on various occasions to make them consistent with international standards. In late 2000, the legal framework of the system was reformed with the publication of the new General Law on Banks, Nonbank Financial Institutions, and Financial Groups, the SBIF Act, and the BCN Act. In addition, in 2001 the Deposit Guarantee Fund (FOGADE) was established.[11] Also in 2001, the legal foundation was laid for a private pension plan system with contributions in the form of individual accounts.[12]

1.10 The structural and regulatory changes in the economy and financial sector translated into considerable growth over the decade. Whereas in the early 1990s, the banking sector had total assets of approximately US$585 million, equivalent to 35% of GDP,[13] by late 2000 they totaled US$1.817 billion, equivalent to 76% of GDP. A decade after the financial system was deregulated, the loan portfolio totaled US$892 million and deposits reached US$1.413 billion (Table I-1 below shows the evolution of the main balance sheet items of system banks and financial institutions from 1998 to June 2002). Like the banking sector, nonbank financial institutions posted considerable growth in the 1990s, in terms of both the volume of resources they managed and the variety of products provided. For example, specialized financial institutions developed, such as bonded warehouses, finance companies, and private insurance providers. As of June 2002, the volume of goods in warehouses managed by bonded warehouses totaled US$40.3 million and the premiums charged on the insurance market reached US$26.8 million. In 1995, the Nicaraguan stock exchange, *Bolsa de Valores*, was established giving rise to a formal capital market. Although currently almost only debt instruments are traded on the Nicaraguan stock exchange, the volume of trade in 2001 was approximately US$602.7 million.

[11] After being postponed several times, the FOGADE Act entered into force on 1 August 2002.

[12] The program to support pension system reform (loan 1089/SF-NI) was approved in 2001.

[13] It should be noted that these statistics are most likely distorted, in terms of both the GDP figures and an overassessment of the assets in the early 1990s.

Table I-1
Development of main balance sheet items for banks and financial institutions
December 1998-June 2002
(in millions of dollars)

	06/2002	**2001**	**2000**	**1999**	**1998**
Assets	2,009.1	1,906.5	1,816.5	1,828.4	1,574.0
Gross portfolio	681.7	696.0	891.8	1,113.1	883.2
Investment	799.1	659.8	365.4	277.7	212.1
Liabilities	1,879.9	1,786.9	1,679.7	1,707.7	1,493.1
Deposits	1,644.7	1,495.2	1,413.7	1,431.8	1,280.3
Capital	129.2	119.5	136.8	120.7	80.8
Earnings	32.9	34.3	24.1	26.7	12.7
Capital adequacy (%)	17.9	16.4	14.3	10.7	9.3
Average growth in %					
Assets	5.4	5.0	-0.7	16.2	-
Gross portfolio	-2.1	-22.0	-19.9	26.0	-
Investment	21.1	80.6	31.6	30.9	-
Liabilities	5.2	6.4	-1.6	14.4	-
Deposits	10.0	5.8	-1.3	11.8	-
Capital	8.1	-12.6	13.3	49.4	-
Earnings	-4.1	42.0	-9.7	110.7	-
Number of regulated IFIs	10	9	11	13	14

Source: Office of the Bank Examiner (SBIF).

1.11 As of June 2002, the Nicaraguan financial system consisted of six private banks, a State-owned second-tier bank, and four finance companies. There were also five insurance companies, six bonded warehouses, one financial leasing company, and 12 seats on the stock exchange. There are no foreign banks operating in Nicaragua, although at least two intermediaries have foreign capital. The financial sector is expanding with a wide range of financial institutions, not only in the supervised formal sector, but also in the unsupervised sector. Among the unregulated, unsupervised financial intermediaries are credit unions and nongovernmental organizations (NGOs). However, the private banks dominate the financial market as measured by the main variables such as assets, portfolio, deposits, and capital (see Table I-2). In June 2002, the five largest banks held over 93% of total deposits and 81% of the total portfolio in the regulated financial system. However, these five institutions, like the market as a whole, were characterized by a high level of competition.

Table I-2
Breakdown of financial system
June 2002
(in millions of dollars)

	Banks[1)]	Financial institutions	Credit Unions [2)]	NGOs [3)]	Total [4)]
Assets	1,930	79	22	64	2,095
Portfolio	629	53	12	52	745
Liabilities	1,810	70	18	38	1,928
Deposits	1,607	38	3	0	1,500
Capital	120	9	4	26	152
Number of institutions	6	4	221[5)]	16	-

Source: SBIF, Annual Reports of the Nicaraguan Microfinance Association (ASOMIF)

1) Does not include banks in liquidation.
2) FNI's own calculations based on data from the Credit Union Office and the 2002 Consultant's Report by Micro Service Consult.
3) Data from the 16 members of ASOMIF.
4) Estimated total.
5) This figure only includes credit unions and does not include multiservice institutions.

1.12 **Bank crisis**. Despite the major progress made since 1990 in sector regulation and prudential standards, during most of the 1990s there was still inadequate, lax supervision and a lack of technical capacity. The rapid growth in risk assets, risk concentration, and the proliferation of related-party lending, compounded by external factors, has led to liquidity and creditworthiness problems and default in four banks since the second half of 2000.[14] The government later had to intervene and close them, and their assets and liabilities were auctioned off to other local banks. As of June 2000, the four banks represented approximately 40% of the assets in the system and 39% of the deposits.

1.13 In view of the size of the institutions in question, and in order to avoid a systemic collapse due to widespread public mistrust[15], the authorities decided to guarantee the entire amount of deposits and most liabilities, covering the gap between assets and liabilities transferred. This "bailout" of liabilities was financed by the BCN

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14 The authorities took control of Banco Intercontinental in October 2000, Banco de Café in November 2000, Banco Mercantil in March 2001, and Banco de Industria y Comercio (BANIC) in August 2001. In addition to these four institutions, Primer Banco Hipotecario (PRI-Banco) was absorbed by Banco de la Producción (BANPRO) in September 2000 prior to an accelerated loss of solvency. BANPRO absorbed Banco Intercontinental and BANIC, while Banco de Finanzas (BDF) absorbed Banco de Café and Banco de Crédito Centroamericano (BANCENTRO) absorbed Banco Mercantil.

15 From June to December 2000, the equivalent of 8.2% of total deposits were withdrawn, the overall figure for that period dropping from US$1.539 billion to US$1.414 billion.

through the issue of medium-term domestic debt instruments (CENIS), equal to almost 16% of GDP.

1.14 The crisis has led to greater concentration and capitalization in the banking sector. By year-end 2001, the banking system consisted of nine institutions regulated and supervised by the SBIF (commercial banks and finance companies) had average assets of US$212 million and an average capital adequacy ratio (CAR) of 16.4%[16] compared with 13 institutions with average assets of US$141 million and a CAR of 10,7% at year-end 1999[17]. System deposits totaled US$1.495 billion, representing 117% of the amount prior to the crisis. It should be noted that subsequently, as deposit rates began to decline, deposits in both local currency and foreign exchange increased by US$150 million from December 2001 to June 2002. This trend indicates renewed confidence in the financial system.

1.15 According to the evaluations conducted by the SBIF, the system is relatively sound, thanks in part to the strengthened supervision and the establishment of prudential standards. The standards are generally in line with the Basle principles and are considered adequate. In addition, monitoring of implementation of and compliance with the standards by the authorities has improved substantially since 1997. As of June 2002, the capital adequacy ratio in the financial system was 17.5%, the simple average for commercial banks being 17.4%. The 10 institutions that make up the entire regulated financial system all met the liquidity reserve requirement and the portfolio in arrears rate was just 3.5%, with average loan loss coverage of 140%. It should be noted that the economy is highly dollarized given that, at year-end 2001, 76.7% of deposits and 82.4% of the loan portfolio was in foreign exchange. The balance was in local currency, indexed to exchange rate fluctuations, so that there was no major currency mismatch in the balances of the financial intermediaries.

1.16 Nevertheless, the current banking system continues to face credit, interest rate, and liquidity risks. Although according to data obtained from the SBIF the loan portfolio shows satisfactory ratios and the liquidity status of the system does not indicate any major short-term risk, attention should be paid to the remaining potential programs, such as concentration of related credits, exchange risks in debtor repayment capacity, commercial risk in specific areas of financing such as

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[16] According to the Basle accord principles, the aggregate primary capital in the banking system was 8.5% as of August 2001.

[17] Five banks left the market and one finance company joined the system.

the coffee sector, and the high concentration of liquity in securities issued by a single issuer (BCN).[18]

D. Credit supply and demand

1.17 On the demand side, private fixed investment increased at the same pace as GDP in 2001, a major achievement considering that it had decreased by 18% the previous year. Public investment declined by 6%, after the high levels achieved in 1999 and 2000 due to the post-Hurricane Mitch reconstruction activities. The economic integration of Central America as a whole with the United States, negotiations for which were launched in 2002, is a good opportunity to accelerate regional integration and enhance trade relations among the Central American countries. Overcoming the climate of political uncertainty, and given the fact that the measures the government plans to take to address the serious fiscal situation and improve the investment climate have led to optimism in the business community, the prospects for 2003 are encouraging, with GDP expected to grow by 3%. Moreover, they have the full support the international community is providing for the fight against corruption, along with the agreement reached with the IMF, the expected recovery of the international economy, and higher domestic and foreign private investment, which will help reactivate production.

1.18 The structural reforms of the 1990s established the private sector as the axis for development. However, despite the economic growth achieved during the decade, Nicaraguan enterprises are still behind in their technology and have competitive disadvantages that limit their potential for growth and job creation until they modernize their production plants. This lack of productive conversion in all sectors is due in part to the fact that the Nicaraguan financial market does not yet have sufficient depth, in terms of both access to services and suitable financial products.

1.19 The most important aspect of the financial system's lack of depth is lack of stable medium- and long-term credit resources available. Financial sector liabilities are predominantly deposits, which accounted for 87.7% of total liabilities as of June 2002 and are generally short-term deposits. Only 22.4% of deposits are fixed-term deposits with terms greater than 12 months and only 6.9% of total deposits have terms above 18 months. This structure contrasts with a placement profile that has been expanding now that confidence in the financial market has been restored after the banking crisis, with 62.7% of operations currently being for terms greater than

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[18] The commercial banks are the principal holders of bonds issued in recent years, particularly through the compensation mechanism established in the bank insolvency agreement. The solvency of the bonds and their rate affect or could affect the financial sector in three ways: (a) they could have a "crowding out" effect on credit demand in the private sector, with adverse effects on credit risk selection; (b) the yields on the bonds could lead to a structural distortion in sector profitability; and (c) the existence of the bonds and their weighted risk could have a significant impact on system CAR.

18 months. Table I-3 below shows the structure of deposits and liabilities by term in the financial system as of June 2002.

Table I-3
Estimated mismatch in financial system terms [1)]
As of June 2002
(in thousands of US dollars)

Assets				
	Gross portfolio by term			
Banks	<18 months (A)	>18 months (B)	Gross portfolio (C)=(A)+(B)	Total assets
BANPRO	55,498	77,144	132,643	552,479
BANCENTRO	43,871	100,315	144,185	437,499
BAC	92,080	33,137	125,217	352,366
BDF	20,525	77,308	97,832	303,655
BANEXPO	14,206	76,824	91,030	199,364
BANCALEY	12,637	25,480	38,118	84,505
Finance Co. [2)]	15,677	36,974	52,652	79,254
TOTAL	254,494	427,183	681,677	2,009,123

Liabilities							
		Term deposits		Financial obligations		Mismatch	
Banks	Savings	<12 months (D)	>12 months (E)	18 months (G)	>18 months (H)	Gap >18 months (J)= (H)-(B)	Gap>18 months (J)/(C)
BANPRO	96,958	114,696	123,860	3,163	44,367	-32,777	24.7%
BANCENTRO	166,863	102,366	24,551	15,436	23,096	-77,219	53.6%
BAC	88,050	96,657	11,367	39	11,761	-21,376	17.1%
BDF	100,332	101,049	28,493	17,795	14,976	-62,332	63.7%
BANEXPO	71,845	27,295	23,318	2,703	10,744	-66,080	72.6%
BANCALEY	20,058	17,831	15,607	1,958	5,868	-19,613	51.5%
Finance Co.	7,901	24,533	5,518	4,463	18,793	-18,181	34.5%
TOTAL	552,034	484,427	232,713	45,555	129,604	-297,579	43.7%

1) The institutions listed account for 100% of the assets and deposits of regulated financial institutions (commercial banks and finance companies) in the system.

2) Includes four finance companies, one of which was authorized in April 2002.

1.20 As of June 2002, just 30% of the assets with terms greater than one year were financed by liabilities with similar terms. As shown in the above table, the mismatch represented close to US$300 million or 43.7% of the total portfolio. Not counting the US$140 million for personal loans and microfinance with terms above

18 months, approximately US$160 million or 23.1% of the total system portfolio was backed only by short-term deposits by the public. This situation limits the banks' capacity to grant credit for viable investment projects.

1.21 After the crisis, long-term funding for commercial banks became extremely difficult, since there was the perception that commercial banks that survived the crisis would continue to increase their loan loss provisioning. Given the scarcity of foreign lines of credit, the most important source of financing was public deposits. Although one of the primary functions of financial intermediaries is to transform the terms for resources, the stability of public deposits in Nicaragua continues to be jeopardized by volatile macroeconomic policies. Bank liabilities highlight the system's vulnerability due to a distinct imbalance in the terms of the sources and application of funds. While the imbalance does not pose an immediate threat to the system, it makes it potentially more vulnerable now to sudden substantial cash withdrawals.

1.22 During the first half of 2002, due to the stagnating demand for credit on the part of the private sector, the economic agents were still willing to purchase liquidity—in the form of government securities—even though their yield had decreased substantially.[19] Despite the decline in deposit rates in the first half of 2002, the portfolio decreased due to lower demand for credit. By the end of the first half of 2002, the main monetary aggregates showed a contraction over 2001. Borrowing rates remained at the same level as the year before. This reflects the past due portfolio problems that a portion of the banks have been experiencing and the bank defaults that have occurred in recent years.

1.23 **Money laundering**. Nicaragua has relatively recent legislation and regulations on money laundering. In 1999, the Law on Psychotropic and Narcotic Drugs and Other Controlled Substances: Laundering of Money and Assets from Illegal Activities" was published, along with its regulations.[20] The SBIF board of directors recently approved specific administrative regulations for the financial sector.[21] A Financial Analysis Committee has been established, made up of the Public Prosecutor's Office, the National Police, and the National Anti-Drug Council, among other agencies, and has approved specific measures against money laundering under the National Plan for the Fight Against Drugs. Nicaragua is a member of the Caribbean Financial Action Task Force and has not been cited in any of the recent reports on money laundering issued by different international organizations. However, there

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[19] As of June 2002, most of the investments held by banks and finance companies consisted of CENIs, which accounted for 41.4% of total investments, TEIs, 21.3%, and BPIs, 14.1%. CENIs had a yield of 17% in December 2001, which dropped to 9% by June 2002. It should be noted that the first half of the year is generally contractive because of seasonal variations in credit.

[20] Law 285 of 15 April 1999 and Decree 74-99 of June 1999.

[21] Resolution on "Regulations for the Prevention of Money and other Asset Laundering", March 2002.

are still some weaknesses in the implementation of control and monitoring systems due to technical and training constraints. The SBIF authorities, like other government agencies, are in the process of strengthening their capacity through international aid and under a technical-cooperation project with the Bank.[22]

E. Small and medium-sized enterprise

1.24 The constraints on access to the financial market and the lack of products generally affects small and medium-sized enterprises, since they are perceived as a greater credit risk by commercial banks.[23] According to data from the Ministry of Development, Industry, and Commerce (MIFIC) for 2000, there are about 159,000 urban and rural enterprises, not counting small and medium-sized agricultural producers. Of these, the vast majority are micro, small, and medium-sized enterprises, with 4,500 small enterprises and 570 medium-sized enterprises. In terms of employment, micro, small and medium-sized enterprises employ some 63% of the nonagricultural economically active population (EAP).[24]

1.25 Although formal small and medium-sized enterprises are extremely diverse, they generally include enterprises that use a relatively more labor-intensive, but can rapidly adapt their productive activity to a more competitive, dynamic business environment. The small and medium-sized sector covers the entire spectrum of private business, but is more highly concentrated in trade and services, while manufacturing accounts for 16.7%. The sector is fast growing, a key factor in setting the country on a path to growth, with great employment-generating potential.

1.26 **Collateral guarantees**. The legal and institutional framework necessary to guarantee loans with collateral (including stock, machinery, chattel, and accounts receivable) is still not sufficiently developed in Nicaragua, which may have severe repercussions on the agricultural sector and small and medium-sized enterprise, as an obstacle to access to credit. The problems involve difficulties and constraints in the establishment, recording, and execution of loans with collateral guarantees. Establishing such a real guarantee is costly and many types of goods are not accepted under security law or as collateral other than real estate. The current institutional framework does not require record keeping that would provide efficient, low-cost government systems to verify whether there are any previous liens on the prospective collateral. Creditors seek to lower these risks by monitoring debtors. The applicable legislation to recover and sell the collateral in the case of

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22 MIF, "Support for the Superintendency of Banks and Other Financial Institutions" (ATN/MT-7975).

23 For purposes of the program, small and medium-sized enterprises will be defined according to the definition used by the Nicaraguan Institute for Support of Small and Medium-sized Enterprises (INPYME), namely enterprises with six to 100 permanent employees.

24 According to the latest available estimates, 60%-66% of the urban employed work in the informal sector.

noncompliance involves such protracted procedures that most collateral guarantees either depreciate before they can be recovered to pay off a loan in arrears or are only used to guarantee very small loans compared with the execution costs.

1.27 To address these problems, the Government of Nicaragua prepared a draft bill on collateral guarantees in 1998, the primary objective of which is to regulate legally binding contracts designed to guarantee fulfillment of an obligation through various types of guarantees. The bill was drafted in cooperation with the World Bank, which also plans to provide additional technical assistance to enhance the draft bill.

F. Financiera Nicaragüense de Inversiones, S.A.

1.28 Financiera Nicaragüense de Inversiones, S.A. (FNI) is an autonomous financial institution with its own assets that is supervised by the SBIF. Its primary mandate is to promote private-sector development by channeling resources through private financial intermediaries subject to SBIF supervision. The FNI was established in November 1993 under its own charter,[25] consolidating the second-tier bank functions of the BCN and various special development funds[26] into a single entity. In July 1998, the FNI was incorporated,[27] with C$1 billion in callable capital and C$510 million in paid-in capital. The paid-in capital was contributed in full by the Government of Nicaragua, the equivalent of 99.98% of the capital, and the BCN, the former reflecting the net value of the FNI's assets upon its establishment.

1.29 The FNI has specific prudential standards, taking into account its exclusive function as a second-tier bank.[28] The FNI is governed by a board of directors chaired by the President of the BCN and made up of four government representatives and one private-sector representative, all appointed by the President of the Republic. The general manager is in charge of management. As of June 2002, the FNI had a total of 44 employees: 11 managers, 18 professional experts, eight administrative staff, and seven service staff.

1.30 **Credit activities and portfolio development**. The primary lending activity of the FNI is multisector financing using the FNI's own resources (66% of the outstanding portfolio as of June 2002). In addition, the FNI implements the credit program to support foreign trade using resources from the Latin American Export Bank of Panama (BLADEX) and other Ministry of Finance (MHCP) programs for small

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[25] Decree 46-93 of 1 November 1993.

[26] The Special Development Fund (FED), Export Promotion Fund (FOPEX), and National Preinvestment Finance Company (FINAPRI).

[27] Law 289 of 27 April 1998.

[28] Prudential Standards for Supervision of Financiera Nicaragüense de Inversiones, S.A. (FNI), June 1998, SBIF board resolution LXXXV-6-98.

enterprise, irrigation, and coffee (see Table I-4). Each of these programs has its own special features with respect to amounts, rates, and terms, and often differ in the terms negotiated individually with the source of funding for each beneficiary. Since it began operations in August 1994, the FNI has financed approximately 112,000 loans for an accrued volume of over US$360 million. Since its restructuring as a corporation in 1998, the FNI has financed approximately 31,000 loans for an aggregate amount of over US$197 million. In addition, the FNI has acted as intermediary for resources from the Netherlands and the United Nations for small business and microenterprise, with a total balance close to US$2 million. The FNI must at all times maintain a 100% maturity match between assets and liabilities.

Table I-4
Terms and maturities of main sources of FNI financing
June 2002

Creditor	Balance in US$ millions	Contract Date	Term in years	Maturity of last payment	Interest rate agreed upon (%)
BLADEX	2.74	March 99	0.5	January 03	4.93
MHCP obligations					
Mitch	4.39	March 99	4	March 03	0.00
Irrigation (Taiwan)	4.41	January 99	20	January 19	3.50
SMEs (Taiwan)	0.29	January 99	20	January 19	3.50
Coffee-growers unpaid balances 2001	9.28	July 01	8	Sept. 09	3.50
Coffee-growers restructuring 2002	0.47	July 02	15	July 05	3.50
Subtotal, regular operations	18.83				
MHCP subordinated debt (BANIC)[29]	3.78	Nov. 01	7	Nov. 07	5.00
Total debt with MHCP	22.61				3.07
Total liabilities with creditors	25.35				3.27

Source: FNI

1.31 In addition to its regular operations, the FNI administers various special programs through trust funds financed by the UNDP, FAO, Government of the Netherlands, and the MHCP, which total approximately US$10 million (this is not reflected in its balance sheet). In its operations using its own resources and general lines of credit, the FNI exclusively serves SBIF-supervised financial intermediaries based on

29 The FNI invested in the subordinated debt of BANIC, a State-owned bank in default, interest payments on which are guaranteed by the MHCP.

predefined eligibility and risk criteria and on market conditions. These standards and principles were established in cooperation with the Bank (under loan 1014/SF-NI; see paragraph 1.50).

1.32 The resources channeled through the FNI are greater because over the past five years the institution has provided private banks with some 40% of their non-deposit long-term resources (see Table I-5). However, since almost 95% of the FNI portfolio is concentrated in loans with maturities greater than 18 months, the structure has not enabled the FNI to maintain high liquidity or to handle variations in the demand for credit and liability maturities. The great imbalance in the terms of the IFIs mentioned above is likely to lead to a major demand for FNI resources.

Table I-5
Structure of financial system and FNI liabilities
December 1998 to June 2002
(in US$ thousands)

	6/2002	12/2001	12/2000	12/1999	12/1998
Long-term funding	129,604	212,999	151,059	206,036	135,043
FNI	62,411	85,832	56,167	71,376	60,398
CABEI and other	67,192	127,167	94,892	134,660	74,645
Long-term portfolio[1)]	287,136	249,411	276,898	306,986	229,163
Investments financed with deposits	157,532	36,412	125,888	100,950	94,119

Source: FNI. Own calculations.

1) Includes loans for agriculture, agribusiness, manufacturing, trade, services, and mortgages, but excluding personal loans and microcredit.

1.33 **Financial statements.** As of 30 June 2002, FNI's assets totaled US$81 million, of which US$67 million, or 83%, was for the net portfolio. Of the total, 64.8% is denominated in foreign exchange, and the remainder denominated in local currency is indexed to the foreign exchange rate. As of June 2002, FNI's reported capital of US$53 million, for a capital adequacy ratio of 65%. To date, the FNI's obligations to financial creditors represent 92% of its total liabilities, with only 10% of them being with foreign institutions, in short-term operations with BLADEX, through a line of credit for foreign trade. At the end of 2001, the FNI had no obligations with the BCN (see Table I-6).

Table I-6
Main FNI balance sheet items and indicators, 1999 – 2002
(in US$ thousands)

	06/2002	03/2002	12/2001	12/2000	12/1999
Total assets	80,891	98,340	99,129	83,117	75,419
Liquid funds and temporary investments	11,101	6,601	4,752	1,075	2,584
Net portfolio	66,928	85,826	88,473	73,808	70,161
Current portfolio	68,871	88,635	91,513	77,200	72,184
Other assets	1,841	2,743	3,475	4,954	1,295
Loans past due	1,011	187	0	0	0
Provisions	-2,953	-2,997	- 3,040	- 3,392	- 2,023
Total liabilities	27,426	45,056	45,989	31,187	24,988
BCN	0	0	0	2,008	3,867
Foreign obligations	2,742	20,343	21,563	9,319	8,997
MHCP obligations	22,612	22,824	22,798	17,737	10,119
Other liabilities	2,072	1,889	1,628	2,123	2,005
Capital	53,465	53,284	53,142	51,930	50,430
Ratios (%)					
Liquid assets/Total assets	13.7	6.7	4.8	1.3	3.4
Net portfolio/Total assets	82.7	87.3	89.3	88.8	93.0
Net portfolio/Liabilities	244.0	190.5	192.4	236.7	280.8
Capital/Total assets	66.1	54.2	53.61	62.48	66.9
Increase in capital	0.3	0.3	2.3	3.0	-

Source: SBIF

1) The significant reduction in the second quarter of 2002 was attributable to lower export credit demand under the BLADEX line of credit, particularly by local marketers of coffee, who raised short-term financing through international buyers.

1.34 Despite this difficult environment, the FNI has managed to obtain positive results over the past few years, posting a return on equity (ROE) of 11.57% and a return on assets (ROA) of 7.21% on average from 1999 to 2001, in addition to positive cash flows. More recently, however, the FNI has generated declining positive results, below the average ROA and ROE achieved since 1998.[30] The figures reflect in part satisfactory risk management and efforts to increase efficiency in the FNI and to control spending, which has been maintained at under 2% of the average loan portfolio (see Table I-7).

[30] The relatively low ROA and ROE figures reflect both the FNI's lack of leverage and the loan loss provisions it aggressively established due to bank defaults to anticipate possible losses.

Table I-7
Main items of FNI statement of profit and losses and indicators
2000 – 2002
(in US$ thousands and %)

	6/2002		12/2001		12/2000	
	US$	**%[1)]**	**US$**	**%**	**US$**	**%**
Financial income	5,244	6.48	10,505	10.60	10,742	12.92
Interest on loans	3,442	4.26	6,918	6.98	7,236	8.71
Interest on investments	171	0.21	517	0.52	54	0.07
	104	0.13	167	0.17	227	0.27
Fees and other charges	1,527	1.94	2,903	2.93	3,227	3.88
Monetary adjustment	694	0.86	1,590	1.60	1,473	1.77
	4,550	5.62	8,916	8.99	9,271	11.15
Finance charges	1,329	1.64	2,071	2.09	1,945	2.34
Gross financial margin	3,220	3.98	6,845	6.91	7,325	8.81
Reserves	722	0.89	1,691	1.71	1,626	1.96
Net financial margin	2,498	3.09	5,154	5.20	5,700	6.86
Operating expenses	625	0.77	996	100	1,207	1.45
Operating margin	1,874	2.32	4,157	4.21	4,492	5.40
Taxes	-	4.16 [2)]	-	4.56	-	5.67
Returns	-	7.26 [2)]	-	8.49	-	9.47
ROA						
ROE						

Source: SBIF and FNI
1) on assets
2) annualized

1.35 **Eligibility and counterparty risk analysis.** The regulations on eligibility for financial intermediaries, which are part of the prudential standards for FNI operation, approved by the board of directors and by the SBIF in 1998, establish FNI's maximum risk exposure, IFI eligibility requirements, and a rating for each IFI according to the quality of the system as a whole. The eligibility criteria include: delinquent portfolio: 5% maximum; compliance with legal reserve, capital adequacy, concentration of related loans, and loan loss provisioning; and assets procured according to SBIF prudential standards. The FNI mitigates the credit risk by establishing limits on IFI exposure depending on their financial position and the makeup of their liabilities. The cap on financing (balance) the FNI may grant a given IFI are: (a) no more than 25% of an IFI's portfolio; (b) no more than three times an IFI's capital; or (c) no more than 25% of the total FNI loan and investment portfolio in a credit recipient, whichever of the three is lowest. In addition, the FNI requires a guarantee coverage for end-loans equal to 125% of the credit, and may require additional guarantees at any time. Furthermore, it reserves the right to automatically debit the cash reserve accounts of the IFIs in the BCN for the payment of interest and principal. The guarantee is made up of bearer securities and credits granted as payment guarantees received in amounts net of provisioning. Approximately 60% of all the guarantees are in the form of securities such as CENIs in book value, or BPIs, in the tradable value on the stock exchange on the date of the transaction, depending on the issue or maturity date. The rules for granting credit financed are set out in the FNI prudential standards and follow a methodology similar to that used by banks.

Table I-8
FNI exposure to IFIs
June 2002
(in US$ thousands and %)

	Portfolio balance	FNI in IFI portfolio 1)	FNI risk assets in IFIs 2)	Rating
BANPRO	22,234	16.8%	35.6% 3)	B+
BANCENTRO	10,677	7.4%	14.5%	B
BAC	5,707	4.6%	7.7%	B
BDF	7,312	7.5%	9.9%	B
BANEXPO	9,083	10.0%	12.3%	B
BANCALEY	4,655	12.2%	6.3%	C+
FINARCA	2,008	22.0%	2.7%	B
FINDELTA	1,272	6.0%	1.7%	B
CONFIA	1,010	7.2%	1.4%	B
(in liquidation)				
BANCAFE	2,144	N/A	2.90%	N/A
BANIC	3,658		4.95%	
Total	69,759			

1) Cap: 25%.
2) Cap: 25%.
3) Since BANPRO took over approximately US$13 million of the Banco Intercontinental portfolio after Banco Intercontinental became insolvent in 2000, the SBIF granted a special waiver on the exposure concentration limit for that amount, which was the equivalent of 14% of the FNI's risk assets at the time.

1.36 The FNI has developed a methodology based on specific software applications and the institutional capacity for counterparty risk analysis. As established in the IFI rating system, it depends on the sum of the following three factors, respectively weighted at 60%, 25%, and 15%: (a) static quantitative assessment; (b) dynamic quantitative assessment; and (c) qualitative assessment. The total weighted amounts comprise a point system through which each IFI can be rated in categories from A+ to E. IFIs rated B or higher are eligible for FNI financing. As of June 2002, the FNI had rated nine IFIs, six of which were private banks and three were finance companies. Of the nine, almost all were rated in low-risk categories B+ or B; only one was rated in risk category C+. Table I-8 shows the IFI ratings as of June 2002, and the FNI outstanding balance and exposure.[31]

1.37 The static quantitative assessment is supported by financial indicators reviewed according to the CAMEL (Capital Adequacy, Asset Quality, Management, Earnings, and Liquidity Management) methodology, which consists of reviewing capital adequacy, portfolio quality and risk assets, administrative management, earnings, and liquidity. The dynamic quantitative analysis is based on a review of monthly performance as expressed in the CAMEL indicators for each IFI. The rating is based on deviations from the mean in the financial system average over a 12-month period. To assess the qualitative aspects of the IFIs, at least every three months reviews are performed of sample IFI records at the IFIs and during project visits, basically reviewing the FNI loan committee assessment. The credit risk of each IFI is monitored monthly based on the financial information provided by the IFIs and validated with the SBIF. As noted in Table I-9, over the past two years FNI credit risk performance has been satisfactory.

Table I-9
Quality indicators for FNI credit assets
2000 - 2002
(IN %)

	06/02	**03/02**	**12/01**	**12/00**
Past due portfolio/gross portfolio	1.45	0.21	0	0
Loan loss provisions/gross portfolio	4.23	3.37	3.32	4.39
Loan loss provisions/past due portfolio (times)	2.92	15.99	0	0
Past due portfolio/equity + loan loss provisions	2.00	0.37	0	0
A, B+, B portfolio[1)] /equity + loan loss provisions	105.11	138.17	151.76	106.93
C+ gross portfolio/equity + loan loss provisions	8.25	8.95	0.25	32.47

Source: SBIF, FNI

1.38 With regard to **pricing**, FNI policy stipulates that the interest rates charged to the IFIs on the loan granted must be consistent with market rates, so that they do not distort the domestic savings market but seek to supplement it. The FNI pricing policy does not allow the FNI to grant loans to IFIs at a rate lower than the real cost

[31] The standard for concentration with respect to IFI net worth is not as restrictive as the other two for assets, since the IFIs are well capitalized. According to the FNI's prudential standards, the maximum amount to be loaned to the system is close to US$125 million, taking into account that the four largest banks are limited depending on the percentage of the FNI portfolio in each IFI, while the other IFIs are limited depending on the percentage of the portfolio funded by the FNI in each IFI.

of borrowing for the IFIs and the cost of its own funding. The FNI offers variable or fixed rates, depending on the financing program and the term of the operation. The benchmark rate is currently determined at the monthly closing of accounts, as the average weighted rate for financial system borrowing, including term savings and deposits and financial obligations of the IFIs (not including IFI borrowings from the FNI itself). The savings and term deposit rates are adjusted according to the reserve level. These calculations are adjusted taking into account the marginal rate on weekly savings deposits and term deposits prior to the calculation, based on the data provided by the IFIs and the BCN, which publishes the marginal rates weekly.

1.39 The FNI adjusts interest rates to the term of the operation with a view to establishing a positive “yield curve”. The FNI lending rate is determined for each of the currencies in which the FNI operates—United States dollars and cordobas—using the same methodology. Table I-11 below illustrates approximately how the FNI dollar lending rate is calculated using average data for the first half of 2002.

Table I-11
Benchmark rate for the financial system and FNI lending rate
Average for first half of 2002

	Deposits								Lending rate
	Sight	Saving	Term deposits						
Percentage[1]	14%	36%	39%						11%
			Term in months	1	3-6	6	9-12	12≥	
			Percentage	8%	6%	7%	9%	12%	
Rate	0%	3.91-5.05%	3.5%-12.2%						5.99-8.59%
Weighting [1]	0%	38%	48%						14%
FNI lending rate[2]		8.77%							

[1] Calculated based on average liabilities during the period.
[2] Adjusted according to reserve requirement of 19.25%.

1.40 The lack of depth of the Nicaraguan financial system makes it difficult to calculate an appropriate “market rate” when no financial institution has a strong enough presence in the market to influence the supply and demand of lending rates offered. Taking this factor into account, the pricing methodology was designed based on a review of financial market behavior, for the primary purpose of not displacing domestic savings. Term deposit rates still show very erratic behavior, with a very wide range of rates within a given bank and a great deal of discretion depending on the client profile, which appears to be the most important discriminating factor in pricing. There are also great discrepancies in the rates among banks. During the first eight months of 2002, the term deposit rates offered by the five major banks varied from 3.85% to 10.74% (six months), 4.50% to 11.27% (12 months), and 4.05% to 12.12% (over 12 months). These discrepancies among banks should theoretically be based on institutional risks perceived by the depositors with varying risk tolerance, but this has not yet been confirmed.

1.41 Furthermore, almost all the IFIs also obtain medium- and long-term financing directly from international creditors, including multilateral agencies such as the International Finance Corporation (IFC), the Central American Bank for Economic Integration (CABEI), the Netherlands Finance Corporation for Development (FMO), and the Inter-American Investment Corporation (IIC),[32] on terms which are generally below the prices the IFIs would have to pay to obtain funding locally or on the private international market.

1.42 As mentioned above, the FNI includes both deposits and obligations in its calculations, given that external creditors are offering medium-term funding at below-domestic market benchmark rates. There is no evidence, however, that the FNI methodology has displaced any domestic savings, given that during the period from 1995 to 2001, deposits increased in amount at an average annual rate of 40% and over the past three years at an annual rate of over 10%, despite the banking crisis. Nevertheless, the FNI recognizes the limitations of its methodology and arbitrarily established a spread on terms that currently increases 10 basis points per year. Table I-12 compares FNI's lending rates with estimated financial sector rates, showing that on the whole it is fulfilling the terms of its charter. The lending rate is included in the conditions precedent for the financial sector loan (1014/SF-NI) and has been fulfilled by the FNI since the first disbursement of that loan.

[32] According to FNI information, these international creditors have granted dollar-denominated financing directly to IFIs for terms of two to seven years at fixed interest rates varying from 5% to 10% and variable rates based on LIBOR (three to six months) plus 250-350 basis points.

Table I-12
FNI lending and borrowing rates
2000-2002
(in %)

	1st half 2002	2nd half 2001	1st half 2001	2nd half 2000	1st half 2000
Operating costs/outstanding portfolio[1)]	1.64	1.95	2.16	1.96	1.90
Weighted borrowing rate [2)]	3.06	5.47	4.33	4.99	4.99
Lending rate[3)]	8.76	8.68	9.19	9.30	9.30

Source: SBIF
1) Average outstanding portfolio
2) Annualized
3) Weighted rate for outstanding portfolio

1.43 For the **allocation of resources and disbursement system**, under the caps on exposure for each eligible IFI, the FNI uses a discount system for disbursements where the FNI receives requests for funding with the respective documentation after the loans are approved and disbursed by the IFIs. The discount is only for operations that have previously been referred to the FNI treasury under the finance planning process. Discounted FNI loans are structured in terms of disbursements and payment according to the respective loan operations funded by the IFIs. In the case of smaller operations, the FNI has opted to discount "packages" of operations using the terms of the loans as the basis for the discount terms. In such cases, eligibility for the loans is verified subsequent to disbursement. The discount operations are formalized through the delivery of the respective notes.

1.44 **Operating capacity.** When it was established, the FNI took over the BCN's private-sector credit operations, including previous operations with the Bank, and in 1995 was designated as the executing agency for the Bank's credit program with institutional strengthening for nonconventional intermediaries (loan 789/OC-NI). By participating in these operations and the sector reform program support by the Bank under loan 1014/SF-NI, the FNI has developed second-tier banking systems and procedures, especially in the areas of counterparty risk analysis and the allocation of exposure limits, risk control, and discount mechanisms.

1.45 **Banking crisis and the FNI.** The FNI's capacity to administer credit risk can be seen in how it managed its exposure with the banks affected by the recent banking crisis. In each case, the FNI maintained some exposure with the banks at the time of its intervention, totaling US$31 million, equivalent to 58% if its capital. Generally, all the banks had been declared ineligible between nine and 12 months prior to liquidation or intervention, with the exception of Banco Intercontinental in 2000 and Banco del Sur in 1999. In both those cases, generalized fraud and falsification of financial statements played a dominant role in their bankruptcy, but the quality of the credits financed and their guarantee coverage has helped avoid any losses during the process. The FNI has established provisions that totaled US$5.9 million as of 30 June 2002, including US$3.7 million for the portfolio received in payment of the balances and US$2.2 million for the outstanding portfolio receivable from Banco de Café. These amounts cover potential losses, estimated to date at US$1 million in the portfolio received from Banco del Sur and US$3 million for the total portfolio of Banco de Café.

Table I-13

FNI exposure to banks closed (in US$ millions)

Banks liquidated	Date of closure	Maximum balance of portfolio	Date of suspension of loan	Exposure at time of liquidation	Expected losses
Banco del Sur	July-99	3.9	May-99	4.01	1.0
PRIbanco	September- 00	0.4	June-00	-	0
Banco Intercontinental	October-00	15.8	July-00	13.89	0
Banco de Café	November- 00	7.4	June-00	5.20	3.0
Banco Mercantil	March- 01	9.5	October-00	4.20	0
BANIC	August- 01	4.4	January-01	4.08	0
Total		41.5		31.39	4.0

Source: SBIF

G. Experiences and lessons learned

1.46 The present operation has been designed, taking into account the successful experiences with earlier programs and the lessons learned and best practices derived from similar Bank operations. The learning experiences can be crystallized as follows (i) establishment of eligibility criteria for intermediaries taking part in order to ensure participation by solvent, less risky institutions, (ii) the need for a motivated executing agency that is qualified to play the role of a second-tier bank efficiently, (iii) establishment of mechanisms for setting the rates on second tier resources at a level that ensures that the resources are priced adequately and flexibly, and (iv) the importance of giving intermediaries the freedom of setting lending conditions that encourage a broad and judicious allocation of resources.

1.47 **Credit program with institutional strengthening for non-conventional intermediaries**. In 1993, the Bank approved a credit program with institutional strengthening for nonconventional intermediaries (789/OC-NI) for the purpose of providing credit for microentrepreneurs in urban and rural areas and improving financial and credit management of nonconventional intermediaries. The program was valued at US$29.5 million, with the Bank accounting for US$23.6 million of the financing. The IDB portion consisted of a loan of US$20 million and US$3.6 million in nonreimbursable technical-cooperation funding. The lending component was implemented by the FNI and the technical-cooperation component by the Instituto de Pequeña y Mediana Empresa (formerly called the Instituto Programa de Apoyo a la Pequeña y Microempresa (PAMIC)).

1.48 This program (789/OC-NI) proved to be a major source of financing for commercial banks and nonbank financial intermediaries. With reflows (payment recoveries), the program has now financed approximately 103,000 loans totaling US$82 million, or four times the amount of the original loan. A large proportion of the credits went to rural areas to finance agricultural activities. The credit component which was fully disbursed in 1999 has not sustained any loan losses.

1.49 The Project Completion Report (PCR) for this program also praised the highly satisfactory performance of the FNI as executing agency for the operation, noting the progress made in strengthening it as an institution. Under the program, the FNI's technical capacity was strengthened in the areas of counterparty risk evaluation and policies and procedures, including Credit Regulations and discount systems, were established for second-tier operations.

1.50 **Financial sector reform**. The Bank has cooperated extensively with the Nicaraguan authorities in the process of modernization and financial sector deepening through sector reform operations and technical assistance. Since 1998, the IDB has been implementing a financial sector reform program (1014/SF-NI) to promote stability in the banking sector and more efficient private banks through the introduction of enhanced prudential standards, reduction in the number of State-owned banks and the elimination of many market distortions, and reform of the legislative framework. Some of the conditions precedent to disbursement of program resources had to do with the FNI, in particular the institution's prudential supervision, the pricing of its resources, and its operating efficiency. The conditions have been fulfilled since the initial disbursement of funds. The Bank's technical-cooperation programs helped to strengthen the banking system in the wake of privatization and to introduce a legal and institutional framework and the state-of-the-art supervision.

H. The Bank's strategy

1.51 In the short and medium term, the Bank's strategy for the country is tailored to bringing about poverty reduction and to fitting in with the goals of the Enhanced Strategy for Economic Growth and Poverty Reduction (ERCERP), which were outlined by the government in July 2001 in the context of the Highly Indebted Poor Countries initiative. One of the three key challenges identified in the Bank's country strategy for attaining the objectives set in the ERCERP is to produce a viable macroeconomic environment by narrowing the internal and external shortfalls through economy recovery. The ERCERP is committed to increasing the resources allocated to improving the quality of life of the poor and to using these resources more efficiently. This would involve more than establishing guidelines for poverty reduction; it would entail reducing extreme poverty. Accomplishing these aims calls for sustained rates of growth of at least 5% a year. In such a setting, the program would mesh fully with the Bank's country strategy since the availability of long-term resources would facilitate development and the expansion of production, thus enhancing business competitiveness and the economy's capacity to create jobs and raise income. Such an initiative seeks to supplement economic reform programs through measures that focus on economic growth and expansion of social programs to combat poverty.

1.52 The Bank coordinates its efforts closely with other multilateral and bilateral institutions to assist the FNI. Specifically, the Bank has established mechanisms with the World Bank, which is preparing a technical assitance operation to provide support for financing for microenteprise and rural areas. Some components of this operation will be carried out through the FNI. The program which does not envisage loan financing, will be supplemented with the activities planned under the present operation, boosting FNI capacity to address the needs of different market sectors. Morover, the Bank working closely with agencies involved in the financing sector, particularly the World Bank and the International Monetary Fund, by participating in joint review and analysis missions.

II. OBJECTIVE AND DESCRIPTION OF THE PROGRAM

A. Objective

2.1 The objective of the program is to contribute to the development of the private sector, particularly small and medium-sized businesses[33] by expanding the supply of long- and medium-term financing available. To achieve this objective, the funding will be made available to the FNI in order to enhance its position as a reliable and

[33] For statistical purposes, the definition of the small and medium-sized business used here is the one of 6 to 100 employees used by the INPYME. This definition will be used for reference throughout the text.

efficient source of financing for the private sector through loans granted by eligible intermediary financial institutions (IFIs). Also, the program will provide technical cooperation funding to strengthen the FNI and to boost its capacity to meet loan demand on a sustainable basis.

2.2 The program will ensure that the banking system has a constant supply of long-term financing to address the needs of the private sector, thus giving continuity to the process of lending to profitable commercial customers and encouraging IFIs to continue developing their installed capacity to grant loans for the projects of small and medium-sized businesses. The program will contribute to the development of the financial system by removing some of the constraints caused by the recent crisis and its remaining effects.

B. Description of the program

2.3 **Multisector credit component (US$36 million)**. The program would provide resources for expanding the FNI's capacity to finance loans from eligible financial intermediaries to the private sector. The proceeds of the program would be used to address the borrowing needs of new and existing companies for: (i) purchase of fixed assets; (ii) broadening of the working capital base associated with expansion, development, or modernization of production; and (iii) procurement of technical and management services in support of investment in fixed assets.

2.4 This component will be carried out in accordance with the Credit Regulations, the main elements of which are described below. The resources would be used solely for FNI operations with formal SBIF-supervised financial intermediaries that satisfy the program eligibility criteria. The subloans would be granted to private manufacturing, commercial, and service companies in all sectors of the economy in both rural and urban areas.

2.5 Although a company's size is not the sole criterion for financing, the Credit Regulations offer incentives so that the funding will benefit small and medium-sized enterprises without access to capital markets and their operations can be financed with long-term financing by limiting the average size of the subloan and establishing a mandatory average time period for the portfolio as specified in paragraph 3.5 (v). Within the boundaries indicated below, the financial intermediaries would be free to set conditions on the loans financed under the program, including deadlines, amortization schedules, and interest rates and would assume all of the lending risks involved in the operations.

2.6 **Technical assistance component (US$900,000).** The specific objective of this component is to engage specialized consulting services to strengthen and boost the institutional capacity of the FNI, and to a lesser extent of IFIs, to provide sustainable financing to businesses in all areas of the private sector. With these resources, the FNI would be better positioned within the Nicaraguan financial system owing to the diversification and quality of the products it presently offers. This component is divided into the following six subcomponents.

2.7 **1. Price determination review.** The methodology now used to price FNI resources is based on identifying the weighted lending rate of the funding received by the IFIs including financing expenses, which reflect the interest paid on deposits in savings accounts and term deposits, which are both adjusted on the basis of the legal reserve, and liabilities to various FNI creditors. If the resources received are for the short term, the price is determined according to the base rate for operations of less than one year, with a mark up for each additional year. This methodology was based on the guidelines of the Bank's financial sector reform program (see paragraph 1.50), applying the concept that any rate below the rate paid on interest bearing accounts would act as disincentive to savings. However, this methodology arrives at only a rough approximation of the exact cost of the resources since the interest rate is based on an FNI lending rate in the local market that is attractive enough to compete with other sources of financing, particularly from external markets, without the need for subsidization. The system now in place should be reviewed and a methodology developed that reconciles the most competitive and favorable rate that the FNI can charge in a market with possible distortions and other suppliers of funds with the aim of not serving as a disincentive to savings in Nicaragua.

2.8 The auction mechanism will also be reviewed to see how viable it is in setting prices and allocating resources. The mechanism could be useful in determining the real rate through competition with intermediaries in those instances where there are no reference long-term rates. In addition to a conceptual definition, the flow of information will need to be improved and the data base designed in order to calculate a figure, including the development of software for the FNI, to obtain results that are reliable and timely.

2.9 **2. Definition and implementation of an FNI strategic plan.** To some extent, the mission of the FNI, as a public corporation, is to become engaged in new activities that maximize profitability, by diversifying its main role as a second-tier financial institution. Before new activities and services can be introduced, however, it is felt that a strategic vision is needed of the institution's role and purpose. This subcomponent would assist the FNI in developing such a strategic vision and in shaping an action plan based on a detailed analysis of the institution's competitive advantages in generating new products and services and proper steps for addressing the challenges before it and their implications in terms of administrative costs.

2.10 Since one of the constraints weighing on the FNI has been its slow growth, a plan of this kind will include an analysis of the country's business climate so that trends in credit demand and supply can be projected. This information will be used to estimate FNI participation and its position.

2.11 **3. Improvements in the credit risk management system.** Although counterparty risk was successfully managed during the 2000-2001 banking crisis and operations with some customers were closed, the crisis also brought out the limitations in the FNI's risk evaluation analysis systems. As a rule, risk analysis has mainly been based on the past performance of IFIs but can give no insight into the likelihood of future deterioration in an IFI's risk rating.

2.12 At the present time, ratings are done monthly on the basis of data furnished by SBIF and BCN. Although the FNI system is comparable to the top counterparty evaluation systems used by other second-tier financial institutions in the region, like these institutions it does not incorporate independent assessment factors derived from market indicators. Because IFIs are not measured against criteria containing benchmarking elements but against variables in the system as a whole, a systemic distortion is introduced. The new system needs to include more projection factors, i.e. be based more on forward-looking analysis in order to anticipate potential market risks. This subcomponent will finance services for improving FNI's credit risk management systems and could include the development of software to supplement computerized tools now in use in order to obtain reliable and timely results.

2.13 **4. New options for attracting funds.** One of the FNIs shortcomings is that its deposit management has been restricted to lending operations conducted by the government. Once the arrangement has been concluded, the government delegates responsibility for implementing it to FNI which does not have the time to search the money and capital markets to arrange for the resources.[34] Apparently, one of the causes of such restrictive management is insufficient information about capital market operations. This subcomponent would help the FNI to look at the opportunities available in the capital market, and identify the institutional weaknesses that need to be corrected. More specifically, financial and legal opportunities that may be available in regional and nonregional markets for placement of debt would be assessed. Once the legal and institutional analysis has been completed, the operating conditions would be evaluated, FNI commercial risk rated, a prospectus prepared, and a work and monitoring plan designed, all of which would comprise a number of different steps.

2.14 **5. Design of new products**. To help expand the market, this subcomponent would finance the development of new FNI financial products such as the granting of partial guarantees for securitization of the portfolio. Another service under

[34] In accordance with HIPC policy, FMI demands that public borrowing be on a concessional basis. In the case of FNI, some ambiguity still exists as to how this should be treated.

consideration by the FNI is the development of a systematized data base for gathering, updating, and dissemination of information on sources of international financing for the private sector, review its operating conditions, promote the use of such sources of financing in business and monitor how credit is raised.

2.15 **6. Environmental management.** Working in cooperation with the Ministry of Environment and Natural Resources (MARENA), the FNI will develop and put in place a better system of environmental management that should be integrated into its evaluation and monitoring system. More specifically, a rapid environmental impact assessment system would be developed for more practical classification in accordance with the national legislation governing activities to be financed under the program. Once the system has been developed, it would be used to facilitate monitoring of the institution's projects.

2.16 Since the loan agreement specifies that the proceeds of the financing may only be used to fund projects which meet the requirements of environmental legislation and which, insofar as is possible, use clean technologies, the different stakeholders will need to be trained in the concepts and benefits of such production systems, with participation by the FNI and the IFIs concerned. The impact that the training has on adopting new clean technologies and its impact on the company's environmental and financial performance will need to be evaluated. Financing will also be provided for dissemination of the requirements of environmental legislation and its regulations.

C. Scaling of the program

2.17 The size of the program is US$37.2 million. Of this amount, US$36 million will be for the credit component, of which US$7.2 million would comprise the local counterpart funding, to be provided by the IFIs and the FNI on an equal basis, and US$900,000 the technical assistance component. The Bank would contribute US$30 million, with the local counterpart funding accounting for the equivalent of 19.3%. The credit component has been estimated on the basis of the FNI's experience with earlier programs, and its anticipated flow of funds based on financial projections in future years, as follows: (1) projections of economic growth, (2) projected private sector investment, (3) expectations for investment in production by the financial sector, and (4) the banking sector's capacity to intermediate medium- and long-term financing. The cost of the technical assistance component has been estimated according to the resources that would be needed to carry out the activities contemplated.

2.18 In the years ahead, GDP is expected to grow at an annual rate of 3% to 5%, in conjunction with a sustained recovery of gross capital formation by the private sector, which is estimated to increase by 10% in real terms. In 2003, an increase equivalent to 18% of GDP is expected, although the improvement for 2002 was only US$50 million.

2.19 In the last two years, assets in the banking system have been growing in real terms between 4% and 5%, or by approximately US$35 million. In such a scenario, aggregate disbursements under the program would not exceed 30% of the increase in bank assets during program execution. The decline in the bank portfolio balance in 2002 coincided with stagnation in the real sector. However, expectations of moderate growth in credit demand have been confirmed, particularly for loans with longer maturities for repair and replacement of productive assets since the uncertainty prevailing in 2000 and 2001 appears to have passed, and stronger economic growth in the United States is expected in the years ahead.

2.20 The growing demand for medium- and long-term financing is reflected in the changes in the deadlines set by banks and finance companies, a large percentage of which have been funded mainly with short-term deposits and resources from the FNI, the principal source of long-term funding. Demand is projected to reach US$48 million over the next three years, increasing at a rate that will exceed the figure for the program. This projection was made between FNI and the IFIs on the basis of the IFI analysis, taking into account their market position, their business strategy, and their prospects for economic growth.

2.21 Although all regulated institutions have the intermediation capacity to place program resources by the deadlines stipulated, the amount would be limited to the results of credit capacity analysis and FNI and IFI leveraging. In June 2002, total risk-weighted assets amounted to US$733 million, with a capital base of approximately US$123 million. This means that the system has more than enough leverage to accommodate the proposed Bank financing. The FNI portfolio increased at an average annual rate of 14% between 1998 and 2001. In 2002, however, the pace slowed. Assuming that the FNI is able to leverage portfolio growth on a par with past performance, as an extremely conservative estimated, US$40 million in financing would be needed over the next three years for the program.

D. Cost and financing

2.22 The cost of the program has been put at US$37.2 million. Of this amount, US$30 million would be drawn on the Fund for Special Operations (FSO) and US$7.2 million would be in the form of local counterpart funding from financial intermediaries participating in the program and the FNI. The cost of the multisector global credit component would be US$36 million and the technical assistance component US$900,000. The proceeds of the Bank financing would be used as follows: US$28.8 million for the global credit component and the remainder for the technical assistance component and inspection and supervision fees. As the FNI lending operations are denominated in dollars, no exchange risk coverage would be required.

Table II-1
Cost of the program
(in US$)

	IDB	Counterpart	Total	%
Credit component	28,800,000	7,200,000	36,000,000	96.77
Technical assistance component	900,000		900,000	2.42
Inspection and supervision	300,000		300,000	0.81
Total	**30,000,000**	**7,200,000**	**37,200,000**	**100.00**

2.23 The terms and conditions of the proposed operation are as follows:

Resources:
Source of financing: Fund for Special Operations (FSO)

Periods:
Amortization: 40 years
Grace: 10 years
Commitment: 30 months
Disbursement: Not less than 36 months
Not more than 48 months

Financing expenses:
Interest rate: 1% for the first 10 years and 2% thereafter
Inspection and supervision: 1%
Credit fee: 0.5%

2.24 It is requested that financing in the amount of US$100,000 be granted retroactively for expenses incurred since 30 June 2002 or within 12 months prior to approval of the program by the Board of Executive Directors, in connection with the technical assistance component, and specifically subcomponents 1, 2, and 3 for hiring specialized consulting services. The reason for this is that the FNI has now begun to make investments in order to ensure that the technical-assistance component is executed smoothly.

III. EXECUTION OF THE PROGRAM

A. Executing agency

3.1 The borrower and the executing agency will be Financiera Nicaragüense de Inversiones, S.A. (FNI), with the guarantee of the Republic of Nicaragua. The FNI has legal capacity to borrow from international institutions provided that the borrowing is authorized by the FNI's board of directors and considered part of the institution's annual financial program[35]. The program will be recorded by means of (i) a loan agreement between the Bank and the FNI, and (ii) a guarantee agreement between the Bank and the Republic of Nicaragua.

3.2 Implementation of the program will fall to the FNI's different line units. The General Manager will coordinate the program. The coordinator and the line units taking part in program activities will be supported by specialized consultants to be hired out of the technical assistance component to provide technical support as required.

3.3 The FNI has the capital, the creditworthiness, and the liquidity to take on such credit obligations as may arise out of the present program. The institution's audited financial statements as of June 2002 show net capital of US$52 million and a liquidity ratio of 92%. Moreover, in recent financial years, the institution's gross financial and operating margins have been positive, with positive returns on equity and on assets, a situation that is indicative of an institution with the financial administration and operating capacity to control the credit risks of its operations and the financial management of its resources. In addition, the FNI has a proper accounting system that combines management of program resources with the institution's general accounting and makes it possible to keep and consolidate information on IFI financial management of the subborrowers.

B. Commitment and disbursement periods

3.4 The commitment period will be 30 months. The disbursement period may not be less than 36 months, nor more than 48 months.

C. Multisector credit component

3.5 The credit component will be governed by the terms of the **program Credit Regulations**, the global intermediation agreements, and the participation agreements that the FNI has entered into with each eligible financial intermediary. The Credit Regulations cover the experience of the microglobal program

[35] Article 3 of Law 289 of 27 April 1998.

(789/OC-NI) and the FNI's current policy (Regulations governing eligibility of financial intermediaries. See paragraph 1.35) and establishes amongst other things (i) the eligibility criteria for intermediaries including risk exposure limits, (ii) eligibility of subborrowers and subloans, (iii) the lending conditions set by the FNI and the intermediaries, and (iv) the requirements that subborrowers must fulfill in respect of environmental and labor legislation in effect in the country. These requirements are described in more detail below:

(i) **IFI eligibility criteria.** All supervised Intermediary Financial Institutions that are duly established in Nicaragua and authorized to conduct financial activities on national territory that satisfy the eligibility criteria set out in the FNI Act and the Credit Regulations. The FNI will be responsible for identifying eligible IFIs to participate in the program in accordance with the most recent information published by the SBIF, the Central Bank, and other regulatory, audit, and supervisory bodies.

To be eligible, the IFI must:

a. be subject to supervision by the SBIF,

b. be in compliance with bank and financial legislation as well as other banking regulations and prudential standards,

c. not be subject to penalties of any kind, special supervision, intervention, or financial restructuring that may be required by the SBIF, the Central Bank, or other regulatory, audit, and supervisory bodies and be known to the FNI,

d. have been given at least a "B" rating in the FNI risk evaluation, based on (a) capital adequacy, (b) asset quality, (c) liquidity, (d) profitability, and (e) administrative quality.[36]

e. ensure that the portfolio in arrears does not exceed 5% of the total loan portfolio.

(ii) **Eligibility criteria for subborrowers.** All private enterprises legally established in Nicaragua regardless of size and area of activity will be eligible under the program. In accordance with banking legislation, such companies may not have a significant relationship with any Nicaraguan financial institution. Ineligible will be any company that:

[36] Of a total of 9 financial intermediaries ranked in June 2002, one had been ranked B+, seven "B", and one "C+" (see table I-8).

a. trades debt paper or shares on securities markets,

b. is considered to be a debtor with a non-arm's length relationship with the FNI or an IFI,

c. is classified as a class "D" or "E" debtor in respect of any IFI in the system, or

d. employs production technologies that are harmful to the environment or public health or that do not comply with labor legislation.

(iii) **Eligibility of subloans.** The proceeds of the loan may be used to finance investment in new and existing companies in any sector of the economy provided that the projects satisfy the requirements of the FNI and the Bank and the production technologies used are not harmful to the environment, public health, or personal safety. The program will finance:

a. the purchase of fixed assets,

b. increases in working capital associated with expansion, restructuring, or modernization of production, and

c. the engagement of technical and management support services for fixed asset investment, including preinvestment and environmental impact studies.

(iv) **Conditions of FNI and IFI financing and placement mechanism.** The FNI will grant loans out of the proceeds of the financing to IFIs as specified in the Credit Regulations, the loan agreement, the general FNI regulations, and applicable legislation. Loans will be denominated in United States dollars, and amortized over a period ranging from 12 months to 12 years, with disbursements and repayments made in accordance with the terms and conditions of the subloans.

The rates charged by the FNI to the IFIs will be set in such a way as to supplement domestic savings and not to cause market distortions. Lending rates to the IFIs must not be lower than the real average cost of borrowing in the financial system and the FNI funding costs (see paragraph 1.38ff) and will be reviewed on a monthly basis. Rates will be adjusted in accordance with the term of the discounted loans. Loans will be made through the discount system set up by the FNI under previous programs and used to administer the resources.

As a condition precedent to the first disbursement of the credit component, the FNI shall submit the results of the policy review and the FNI rate-setting mechanism for the IFIs. The cost of the consulting services engaged to handle this task may be financed retroactively provided that the consultants have been hired in accordance with Bank procedures.

The IFIs and/or the FNI must fund at least 20% of the amount of each loan.

(v) **Conditions of the subloans.** To the extent permitted under the Regulations, the IFIs will be free to determine the amounts of the subloans, the currency in which they are denominated, lending rates and fees, and how they are paid and the terms, grace periods, and amortization periods, based on a credit analysis of the subloans and the execution period of the projects. The IFIs will assume all credit and exchange risks and will be solely responsible for recovery of the subloans granted under the program. The subloans may not be guaranteed in part or in whole with guarantees funded by the FNI.

The credits will be used to finance long-term investments, granted for a simple average portfolio term of not less than thirty-six months[37] or more than 12 years. The minimum duration of the subloans will be 12 months.

The simple average aggregate amount of credits granted by any intermediary out of the proceeds of the financing may not exceed US$100,000. The average terms and amounts will be reviewed quarterly to ensure that these conditions have been fulfilled. Any deviations from these thresholds must be corrected within 30 days.[38]

The maximum exposure to any subborrower under the program may not exceed US$250,000.

The subborrowers will assume responsibility for all taxes, charges, levies, rights, and duties that may be payable under national law.

(vi) **Environmental and social impact.** For all subloans that are eligible for financing under the program, companies and projects

[37] Two of the four companies regulated by the SBIF engage mainly in microcredit financing. The main activity of the others is financial leasing, where the simple weighted average portfolio duration is 37 or 38 months.

[38] FNI feels that establishing thresholds in this way will give the IFIs greater flexibility in the use of the funds, without deviating from the objectives of the program.

must satisfy all environmental legislation in effect in the country and have the necessary permits issued by MARENA[39]. In the case of subloans for investments designated as having adverse environmental effects under the national environmental classification system, the IFIs or FNI will keep on file copies of all documentation from the national environmental authorities attesting to the company's operations and confirming that the investment fulfilled all environmental requirements prior to disbursement of funding for the subloan. In the case of activities considered "high risk" by the environmental authorities, the IFIs or FNI must keep copies of all authorizations, environmental assessments, and mitigation plans approved prior to disbursement of funds to the IFI as well as all permits required in connection with the mitigation measures ordered by MARENA during execution of the subloan. Failure to implement the mitigation measures that MARENA has ordered will be grounds for immediate termination and repayment of the subloan and the IFI financing.

In addition, the proceeds of the program may not be used to finance projects that involve the exploitation of natural resources when the property on which the project is sited is the subject of dispute or a claim, or the requester does not have valid legal title to the property.

(vii) **Penalties and suspension.** Failure on the part of an IFI or a subborrower to comply with the terms of the Credit Regulations will cause, allowing for a period to make the necessary adjustments, the immediate termination of the operation and suspension of all further financing.

As a condition precedent to the disbursement of the credit component, the Credit Regulations must be approved by the board of directors of the FNI, as agreed with the Bank.

3.6 In addition, the FNI shall ensure during the program that: (a) loans in arrears do not exceed 1.25% of its total loan portfolio; and (b) operating expenses in the preceding 12-month period do not exceed 2% of its average portfolio for the same period.

[39] In accordance with the Environmental and Natural Resources Act (Law 217) passed in 1996, an environmental permit must be obtained in advance from MARENA for projects or any other activity that, given their nature, may be harmful to the environment or natural resources. Pursuant to these regulations, such projects or activities have mainly to do with manufacturing. An environmental impact study must be performed and approved before a permit will be issued for any of these restrictive activities.

D. Technical assistance component

3.7 The implementation of this component will be governed by the plan of operations for technical assistance, which sets out its specific objectives, together with the goals, actions, and the amount of the financing. The proceeds of this component will be used mainly to engage specialized consultants and to a lesser extent to allocate resources for training in specific areas and for dissemination. The plan of operations must be submitted, to the Bank's satisfaction, as a condition precedent to the first disbursement.

E. Environmental and social feasibility

3.8 The direct environmental impact of the program will be neutral since the financing is for second-tier bank operations. Nonetheless, the program recognizes that there may be some adverse environmental effects resulting from individual investments. To this end, valid environmental permits must have been issued by the authorities of MARENA, in accordance with national legislation, in respect of the companies receiving financing and the investments financed under the program. The Credit Regulations must stipulate that the FNI and the intermediaries are responsible for establishing mechanisms for monitoring compliance with MARENA environmental regulations by companies receiving financing and that companies failing to do so will not receive any financing. The intermediaries will consider the environmental risks in their credit analysis and will make information on this point readily available.[40]

3.9 The operation acknowledges that responsibility as the ultimate institutional authority for ensuring the definition, introduction, and implementation of the standards for environmental protection and upgrading rests with MARENA, or any other entity so designated.[41] To help implement the environmental protection measures and the periodic review of the program, the FNI will designate a senior management official to serve as a liaison with MARENA on a permanent basis, with whom agreement will be reached on mechanisms for coordination and cooperation to facilitate compliance with environmental regulations. Moreover, the technical assistance component will make financing readily available to develop practical mechanisms for identifying and monitoring companies and projects to ensure that they comply with environmental mitigation requirements, and to

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[40] While the program was being prepared, specialized environmental consultants were hired and an environmental assessment was performed.

[41] The Executive Power Organization, Authority, and Procedures Act of 1998 (Law 290) expressly instructs MARENA to coordinate its efforts with other competent institutions such as the Ministry of Forest Agriculture and MIFIC. It further establishes that, within the scope of its authority, all public sector agencies must provide for and plan protection and unconditionally nonharmful effects of the environment and natural resources, a situation that would strengthen MARENA's supervisory capacity as an institution.

provide training on environmental risks to FNI and IFI staff and on activities for promotion and dissemination (see paragraph 3.5 (vi)). Failure to comply with these conditions will be grounds for immediate termination and repayment of the credit operation and denial of all further financing.

3.10 The credit agreements and the Credit Regulations will establish that applications for credit under the program may not be denied on the basis of gender or social status. Also, the end borrowers will have the obligation to comply with the requirements of pertinent labor and social legislation.

F. Revolving fund

3.11 A revolving fund in an amount equivalent to 10% of the program will be set up to cover payments that may need to be made under the credit and technical assistance components. The revolving fund will be sufficient to ensure that the program proceeds smoothly and based on experience with operations of a similar nature this amount is justified.

G. Procurement of goods and services

3.12 Procurement of goods and services will be governed by Bank policies and procedures. In the case of consulting services, international competitive bidding will be compulsory for contracts valued at or more than the equivalent of US$200,000. The program does not involve construction works or procurement of goods valued at more than the equivalent of US$250,000.

H. Use of program recoveries

3.13 Recoveries of loans granted by the IFIs in excess of the amount required to repay the borrower's loan obligation, with the exception of resources for short term cash management, may only be used for new loans to IFIs in accordance with the conditions of the loan contract and the corresponding Credit Regulations. Five years after the final disbursement under the program, the Bank and the borrower may agree to apply recoveries to other uses provided that such loans are consistent with the general objectives of the program.

I. Inspections

3.14 The borrower will be required to allow the Bank to perform inspections at any time on the status of the program and to review such records and documentation pertaining to its implementation as the Bank may deem appropriate. The borrower will cooperate fully in this endeavor. The sum of US$300,000 will be deducted from the loan amount for this purpose. All aspects relating to supervision and monitoring of the program will be carried out by the Bank's Country Office in Nicaragua.

J. Monitoring

3.15 Under the program, approximately 360 loans are expected to be granted over a period of three years, in an average amount not exceeding US$100,000 and with an average maturity of three years. The program will focus on evaluating the impact of the operation on the financial market and private-sector financing, taking into account the limitations of methodology and statistical constraints. With this in mind, and based on information provided by IFIs, the data gathered by the FNI and statistical and analytical information from other sources, the FNI will present semiannual summary reports that follow up on the program, within 30 days after the end of each calendar six-month period. The reports will provide information on the status of the financing and how the revolving fund has been used. The FNI will present its final report on the program within 90 days after the final disbursement.

3.16 Although the program resources will go to projects in all sectors of the economy, and the activities and financial products to be used will be determined by market demand, as the program is monitored, the following criteria will be reviewed: (i) the number and size of companies served and loans granted, (ii) break down by sector of the companies served and their nature, (iii) break down by sector of the loans granted and their nature, including amounts, periods, and interest rates, (iv) break down by environmental classification of investments and companies receiving financing in accordance with MARENA criteria, including the findings of the environmental studies and mitigation measures ordered[42]; (v) number of participating IFIs and a break down of the resources , (vi) progress made in expanding the FNI's and IFIs' long-term funding base through capital market instruments and products; (vii) the extent to which the technical assistance objectives and actions have been fulfilled; and (viii) the status of the FNI portfolio in arrears and documentation pertaining to the status of operating expenses.

3.17 The concept of providing financing for projects based on demand for private-sector activities in all areas of the economy is a challenge and, ever mindful of the difficulties entailed in measuring ex ante the specific results, the effectiveness of the program will be gauged, applying the indicators set out in Table III-1 (see logical framework for details).

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[42] The evaluation will look at a sample of companies financed under the operation that have been selected randomly for each participating IFI. The analysis will indicate the frequency with which mitigation measures were recommended and the proportion of the borrowers that complied with the recommendations.

	Table III-1	
Output (during execution)	**Outcome (upon completion)**	**Impact (in medium and long term)**
US$28.8 million has been funneled to the IFIs by FNI through projects for small and medium-sized business in particular.	Medium- (18-60 months) and long- (over 60 months) term portfolio of IFIs participating in program increase by an average of 12%, with a distinction being made between IFI resources and program resources.	Investment in production, particularly in small and medium-sized businesses rises at a faster rate commencing in 2006 than in the preceding five-year period.
Participating IFIs have granted 360 loans in an average amount of US$100,000, with an average amortization period of at least 36 months.	SMEs as a share of the total financial system portfolio rises from 8% in June 2002 to 18% in June 2002.	Sales of beneficiary SMEs are up at a faster rate commencing in 2006 than in the preceding five-year period.
Action plan formulated on completion and approved by board of directors.		
FNI system supplements actions with (a) gauging IFIs against independent criteria that eliminate the systemic bias; and (b) factors of projection and prevention to anticipate potential market risks.	FNI loan portfolio for SMEs increases at an average annual rate of 4% (above trend) and FNI's global portfolio increases at an average annual rate of 8% in the five-year period to 2006.	The number of new jobs created by beneficiary SMEs rises at a faster rate commencing in 2006 than in the preceding five-year period.
Systems for price determination and price allocation mechanism applied.	The operating ratio declines to or below 1.75% upon completion of the program.	
Funding strategy and mechanism prepared and approved by the board of directors.	In the five-year period commencing with startup of the program, arrears in the intermediation portfolio are kept to 0%.	
Supply of new products		

3.18 The executing agency will maintain bookkeeping systems and internal accounting controls for the program to the Bank's satisfaction. The FNI accounting system will segregate the resources for the two components (multisector credit and technical assistance). The executing agency will be required to submit to the Bank semiannual financial reports on the status of the financing and use of the revolving fund within 60 days after the end of the corresponding six-month period. Also, external audits of the program and the executing agency will be performed every year by a firm of independent auditors acceptable to the Bank, in accordance with terms of reference agreed on in advance. The audits will cover management of the program and its operating, financial, and technical aspects, and will be presented to the Bank within 120 days after the end of the financial year.

K. Evaluation

3.19 The borrower will use its own administrative resources to conduct an evaluation of the operation based on terms of reference to be agreed with the Bank as a condition precedent to the final disbursement. The mechanisms for monitoring and periodic evaluation mentioned above, including the final report, will furnish supplementary information for evaluating the impact of the operation and the possibility of extracting lessons from the program. Such an evaluation will be carried out when the program resources have been fully disbursed and 50% of the subloans have been reimbursed in order to ascertain the program impact. The limitations in terms of methodology and volume in determining the impact of the operation on different potential impact variables will be recognized and adjusted to conform to the indicators.

IV. JUSTIFICATION AND RISKS

A. Justification

4.1 The program is an important tool in the process of modernization and industrial development since it will provide the country with a stable source of long-term financing to supplement other internally available means of financing. The operation would therefore be part of the Bank's support for the Nicaraguan authorities in their efforts to seek sustainable economic growth through higher productivity and a more competitive private sector. This goal calls for constant replacement and expansion of productive assets, a process that demands access to sources of sustainable medium- and long-term financing. Given the inchoate development of domestic capital markets and the significant hurdles barring access to these markets, the main sources of financing are the banking system. However, the banks, too, are up against constraints on long-term funding given the nature of domestic resources which place limits on the changing of deadlines. Recognizing the need to strengthen the mechanisms for channeling national savings to productive investment, a program like the one proposed here would go a long way towards making more financing available for encouraging sound private investment and particularly for spurring the development of small and medium-sized business and enabling this sector to penetrate world markets. The modernization and diversification of the production base is expected to bring with it benefits in terms of business competitiveness, production of goods and services, and job creation.

4.2 Although the increase in the internal debt raised the price of credit and diminished the amount of financing available to the private sector, the government is committed to deepening the financial sector reforms and to stimulating development of long-term savings, as reflected in the social security reform. While waiting for these reforms to produce the desired benefits, the funding the FNI receives from the Bank will continue to be a leading source of stable medium- and long-term financing.

B. Risks

4.3 The success of the program will depend largely on whether the country is able to pursue a stable macroeconomic policy conducive to expanding economic activity and private sector demand for credit. In particular, the level of savings, which is not high enough to reduce internal debt because of the economic slow down, continues to be a concern despite improvements in the government's fiscal management. However, the introduction of the program should provide a major incentive for economic activity, which will in turn contribute to higher tax revenues, based on the government's commitment to putting its financial house in order through tax reform and to adhering to a policy of fiscal and monetary discipline. In addition, the recent agreement with the IMF will facilitate the disbursement of approximately US$90 million in loans from multilateral institutions, thus raising confidence of local and foreign investors.

4.4 The program faces the risk that the economy may contract more than is currently projected because of the slow down in economic activity in the country's principal trading partners and a further deterioration in the terms of trade. This could have an impact on the magnitude of investment, thus adversely affecting the rate at which the program is disbursed. The program, which has been scaled on the basis of an estimate of the incremental resources that are required to meet the potential demand of the manufacturing and financial sectors and the financial sector's leverage capacity or its capacity to absorb long-term credit should mitigate this risk mainly on the strength of a conservative scaling of the credit component and its long-term execution. Demand for credit in the medium and long term is expected to strengthen through the restoration of confidence in the financial system.

4.5 In recent years, five banks have gone under, a situation that is indicative of the shortcomings in the regulatory and institutional framework. The vulnerability of the financial system in the aftermath of the crisis could pose serious potential risks to the operation from the standpoint of counterparty risk and credit demand since the program will only finance eligible intermediaries that satisfy certain criteria related to financial condition and fulfillment of bank regulations. Consequently, there will not be a large number of eligible entities. This risk will be minimized considerably by the progress made in Nicaragua in recent years in introducing prudential standards and strengthening financial regulation as well as in enhancing the supervisory capacity of the authorities.[43] Also, the government's ongoing commitment to reform will heighten sector competitiveness, increasing the market requirements for fulfillment of international standards and regulations. In this way, the negative experiences of investors and savers should be gradually overcome, changing expectations and bank and corporate practices, while no dramatic breakthroughs in sector modernization are to be expected.

4.6 On an operational level, the program should not encounter any significant risks since the FNI has been successful in the past in implementing similar operations, including the Bank's microglobal program, which highlights the FNI's capacity for project administration. This operation has made it possible to establish and refine the policies and systems that are needed for a second-tier bank to perform efficiently while enabling intermediaries to adapt to program requirements. In addition, the risk would be reduced considerably by the technical assistance.

[43] The MIF project (ATN/MT-7975) approved in 2002 to boost SBIF capacity for the banking and nonbanking sectors will further mitigate this risk.

GLOBAL MULTISECTOR CREDIT PROGRAM (NI-0167)
LOGICAL FRAMEWORK

Narrative Summary	Indicators	Means of verification	Assumptions
Goal: Support the development of the business sector, particularly small and medium-sized enterprises.			(Sustainability) 1. Ongoing commitment on the part of the government to maintain an efficient financial sector structure and to apply stable macroeconomic policies. 2. Changes in administration are orderly. 3. The rule of law exists and legal certainty.
Purpose: FNI serves as a stable and efficient source of long-term financing for an expanded business sector, mainly for small and medium-sized enterprises.	1. Medium- (18-60 months) and long- (over 60 months) term portfolio of IFIs participating in program increase by an average of 12%, with a distinction being made between IFI resources and program resources. 2. SMEs as a share of the total financial system portfolio rise from 8% in June 2002 to 18% in June 2006. 3. FNI loan portfolio for SMEs increases at an average annual rate of 4% (above trend) and FNI's global portfolio increases at an average annual rate of 8% in the five-year period to 2006.	1. FNI semiannual progress reports; and PCR. 2. FNI semiannual progress reports; and PCR. 3. FNI semiannual progress reports and ex post evaluation of the program.	1. Macroeconomic conditions are backed up by sound and stable policies (investments, money supply, prices, inflation, fiscal, etc.). 2. There exists an environment conducive to business development (strengthening of the rule of law, ownership regime, public security, etc.)

Narrative Summary	Indicators	Means of verification	Assumptions
	4. The operating ratio declines to or below 1.75%. 5. In the five-year period commencing with startup of the program, arrears in the intermediation portfolio are kept to 0%.	4. FNI semiannual progress reports, midterm evaluation, and PCR. 5. FNI semiannual progress reports, audited annual financial statements, and ex post evaluation.	
Components: 1. Medium- and long-term resources channeled mainly to small and medium-sized businesses by participating IFIs increased.	1.1 Upon completion of the program, US$28.8 million has been channeled by the FNI to IFIs to finance projects, mainly for small and medium-sized enterprises (companies with from 6 to 100 employees) 1.2 Upon completion of the program, IFIs participating in the program have granted 360 loans in an average amount not exceeding US$100,000 (maximum of US$250.000) using program resources. 1.3 The average amortization period is not less than 36 months, with a minimum of 12 months and a maximum of 12 years.	1.1 FNI semiannual progress reports, and PCR. 1.2 FNI semiannual progress reports based on information furnished by IFIs. 1.3 Idem.	Access to medium- and long-term credit is a significant factor in determining capacity to generate revenue for the business sector, particularly small and medium-sized enterprises.
2. IFI resource pricing systems set up within FNI.	2.1 Price setting system and resource allocation mechanism in use from the final quarter of year one of the program.	2.1 FNI semiannual progress report, copies of consultants' reports, and on site inspections.	
3. Strategic medium- and long-term plan formulated and adopted by FNI.	3.1 An action plan formulated at the end of year two and approved by the board of directors midway through year three, based on a detailed analysis of the institution's competitive advantages in terms of creating job and producing new products and services, and suitable administrative cost measures in place.	3.1 Copy of the plan and the decision adopted by the FNI board of directors; mid-term evaluation.	

Narrative Summary	Indicators	Means of verification	Assumptions
4. Efficient credit risk management systems established within FNI.	4.1 FNI system supplements actions with (a) measures to gauge IFIs against independent criteria that eliminate the systemic bias; and (b) forward-looking and preventive factors to anticipate potential market risks commencing in year four of the program.	4.1 FNI semiannual progress report, copies of consultants' reports, and on site inspections. 4.2 Idem; and mid-term evaluation.	Access to medium- and long-term credit is a significant factor in determining capacity to generate revenue for the business sector, particularly small and medium-sized enterprises.
5. New funding mechanisms relating to national and international capital markets.	5.1 Strategy and funding mechanisms prepared and approved by the board of directors at the end of year three of the program	5.1 Idem.	
6. New financial products developed by FNI.	6.1 Supply of new products for IFIs at the end of year three.	6.1 Idem.	
7. Environmental management system set within FNI and IFIs.	7.1 Practical environmental impact classification system 7.2 Coordination with MARENA 7.3 Training for staff of FNI and IFIs 7.4 Promotion and dissemination	7.1-7.4 Idem	
Activities 1.1 Promote the program amongst IFIs. 1.2 Grant credits in accordance with demand and the Credit Regulations.	Corresponds to budget for each component under the program.	Project progress reports FNI accounting records	a. Evidence of effective demand by IFIs to take part in the program. b. The economy grows at the same average rate as in the preceding five-year period. c. Sufficient demand for credit on the part of eligible SMEs and borrowers exists. d. IFIs fulfill the Credit Regulations eligibility criteria.
(Components 3 and 5) 2.1 Prepare the terms of reference. 2.2 Hire specialized consultants.			

Narrative Summary	Indicators	Means of verification	Assumptions
2.3 Supervise the consulting work. 2.4 Complete the first draft of the document 2.5 Review by the board of directors 2.6 Incorporate suggestions 2.7 Presentation of final proposal to the board of directors and approval.			e. International lenders offer loans at rates that are equal to or higher than the reference rate used by the FNI. f. Sufficient proposals received in time from specialized consultants within the financial parameters.
(Components 2 and 4) 3.1 Prepare the terms of reference. 3.2 Hire specialized consultants. 3.3 Supervise the consulting work. 3.4 Review by the board of directors. 3.5 Notify the SBIF of the new credit management system. 3.6 Implement the system: interest rate and risk management.			
(Component 6) 4.1 Prepare the terms of reference. 4.2 Hire specialized consultants. 4.3 Supervise the consultants' work. 4.4 Review and approval by the board of directors. 4.5 Offer new products developed for the market.			

Narrative Summary	Indicators	Means of verification	Assumptions
(Component 7) 5.1 Prepare the terms of reference. 5.2 Hire consultants and trainers. 5.3 Establish the environmental management system. 5.4 Promtoe and disseminate the information on environmental management			